Supreme Court, U.S.
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In the

Supreme Court of the United States

October Term, 1998

IN THE MATTER OF: SOUTHMARK CORPORATION,

Debtor.

SOUTHMARK CORPORATION,

Petitioner,

v

COOPERS & LYBRAND L.L.P.,

Respondent.

On Petition for Writ of Certiorari to the United States Court of Appeals for the Fifth Circuit

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BRIEF IN OPPOSITION TO PETITION FOR A WRIT OF CERTIORARI

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COUNTER-STATEMENT OF QUESTION PRESENTED

Whether claims alleging official misconduct by bankruptcy court-appointed professionals constitute core bankruptcy proceedings.

DISCLOSURE STATEMENT

Pursuant to Supreme Court Rule of Procedure 29(6), Respondent Coopers & Lybrand L.L.P. has no parent corporations and no wholly-owned subsidiaries. Effective July 1, 1998, Coopers and Lybrand L.L.P. and Price Waterhouse LLP combined their practices to form Pricewaterhouse Coopers LLP.

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ARGUMENT

The fact-based decision of the court below does not conflict with any decision of this Court or of any Court of Appeals. The Fifth Circuit's holding that state-law contract and tort claims asserted by Southmark Corporation ("Southmark") against Coopers & Lybrand L.L.P. ("Coopers") were a core bankruptcy proceeding because they arose out of alleged misconduct in Coopers' performance of its duties as the accounting firm appointed by the bankruptcy court in Southmark's Chapter 11 bankruptcy is in accordance with Congress' grant of jurisdiction to bankruptcy courts, 28 U.S.C. § 157 (b)(1), and with this Court's decision in *Northern Pipeline Co. v. Marathon Pipe Line Co.*, 458 U.S. 50 (1982).

I. The Decision Of The Fifth Circuit Maintains The Constitutional Limits Prescribed By *Marathon*.

Under *Marathon*, bankruptcy courts exercise jurisdiction over actions that fall within "the core of the federal bankruptcy power," which the Court described as "the restructuring of debtor-creditor relations." 458 U.S. at 71. To determine whether a proceeding resides within that core bankruptcy power, it is settled that a court cannot focus exclusively on whether the claims arise under state law, or can be resolved under state law. *See* 28 U.S.C. §157(b)(3) ("A determination that a proceeding is not a core proceeding shall not be made solely on the basis that its resolution may be affected by State law."); *Arnold Print Works, Inc. v. Apkin (In re Arnold Print Works, Inc.)*, 815 F.2d 165, 169 (1st Cir. 1987) (Breyer, J.); *see also Commodity Futures Trading Comm'n v. Schor*, 478 U.S. 833, 853 (1986) ("[T]here is no reason inherent in separation of powers principles to accord

the state law character of a claim talismanic power in Article III inquiries."). Instead, the court should inquire into the nature of the proceeding—how the proceeding relates to the basic function of the bankruptcy court. *See Arnold*, 815 F.2d at 169. Under this analysis, the Fifth Circuit's fact-bound decision is consistent with the constitutional scope of the bankruptcy power enunciated in *Marathon*.

A. Southmark's Claims Are In The Nature Of A Challenge To Cooper's Disinterestedness As A Bankruptcy Court-Appointed Professional.

Southmark's claims against Coopers for breach of contract, fraud and deceit, breach of fiduciary duty, and negligent misrepresentation arise out of Coopers' alleged misconduct as the bankruptcy court-appointed accountant for the examiner in the Southmark bankruptcy case. Pet. at 57a-72a. For example, in its fraud and deceit count, Southmark alleged that

> Coopers represented to Southmark that the reason Coopers did not develop claims against Drexel was because of lack of time, lack of corroborative evidence, and the fact that Drexel had filed for bankruptcy. In fact, however, Coopers never intended to investigate claims against Drexel, its largest audit client, and it deliberately suppressed evidence concerning such claims developed by one of its managers.

Pet. at 69a ¶36. Similarly, Southmark's breach of fiduciary duty count alleged that Coopers "subvert[ed] the

investigation of claims against Drexel in the interest of Drexel and contrary to the interest of Southmark." Pet. at 70a ¶39.

Southmark does not contest that its claims are based on Coopers' alleged bias in performing its duties as the court-appointed accounting firm, but argues that the "substantive nature" of the claims is that they are "state-created private rights," based in large part on the fact that the claims arise under state law and are to be decided through application of standards supplied by state law. Pet. at 11-12. The argument that a proceeding is non-core because it will be resolved under state law has been explicitly rejected in the Bankruptcy Code. *See* 28 U.S.C. §157(b)(3).

Southmark's claims cannot be divorced from the bankruptcy context within which they arose. Like an examiner or a trustee, a court-appointed professional is a creature of the bankruptcy process. As such, it owes a duty not only to the estate on whose behalf it was retained, but also to the examiner/trustee, the creditors and the court, and no claim against it can be determined without consideration of these varied obligations. The duties of Coopers and any claims against Coopers for its alleged breach of those duties are dependent upon its role in the bankruptcy process and could not exist but for that process.

B. Ensuring The Disinterestedness Of Court-Appointed Professionals Is Essential To The Proper Functioning Of The Bankruptcy Court And Therefore Is Within The Core Bankruptcy Power.

Court-appointed professionals play a prominent role in the bankruptcy process and, as was the case here, are often entrusted with significant responsibility in connection with the administration of the bankruptcy estate. In recognition of the role played by such professionals, the Bankruptcy Code requires that professionals "do not hold or represent an interest adverse to the estate, and that [they] are disinterested persons." 11 U.S.C. §327(a). The disinterestedness requirement, in particular, is strictly enforced in order to maintain the integrity of the bankruptcy process. *See In re Diamond Mortgage Corp.*, 135 B.R. 78, 90 (Bankr. N.D. Ill. 1990); *see also Pierson & Galen v. Creel & Atwood (In the Matter of Consolidated Bancshares, Inc.)*, 785 F.2d 1249, 1256 n.6 (5th Cir. 1986). To that end, bankruptcy courts are charged with an ongoing obligation to "root out impermissible conflicts of interest" whenever they arise. *Rome v. Braunstein*, 19 F.3d 54, 58 (1st Cir. 1994) (quotation omitted); *see In re Vebeliunas*, No. 98 B 45466, 1999 WL 152577, at *3 (Bankr. S.D.N.Y. Mar. 10, 1999) (the disinterestedness requirement "is so crucial to the proper functioning of the bankruptcy system," the court may address any alleged lack of disinterestedness whenever the issue arises) (a copy is attached at Appendix 34b).

The non-core claims in *Marathon* and *Granfinanciera S.A. v. Nordberg*, 492 U.S. 33 (1989), upon which Southmark relies, are of an entirely different nature than the claims raised by Southmark. In *Marathon*, the debtor asserted a contract

claim against Marathon in relation to a pre-petition agreement to construct a pipeline. *Granfinanciera* involved an action in which the bankruptcy trustee alleged that a non-creditor had received a fraudulent conveyance from the debtor prior to bankruptcy. In both cases, the claims related to pre-petition conduct that possessed neither a temporal nor structural nexus to the bankruptcy process. In contrast, Southmark's claims against Coopers arose during and in the conduct of the bankruptcy proceeding; without the bankruptcy proceeding, Coopers would have had no relationship with Southmark and the claims would not exist.

Southmark's own Motion to Reconsider Award of Fees to Coopers & Lybrand and Brief in Support Thereof (a copy is attached at Appendix 1b) demonstrates the core nature of its claims:

> Shielding one of its largest clients from claims that could have substantially enhanced creditor recoveries was plainly inimical to the interests of Southmark's creditors and a violation of Coopers & Lybrand's fiduciary and statutory duties. . . . *[T]his type of misconduct threatens the very integrity of, and the public trust in, the bankruptcy process.*

¶58 (emphasis added). Southmark argued further that Coopers' conduct constituted fraud on the court, which Southmark described as "fraud committed by an officer of the court *which affects the judicial machinery in such a way that the judicial machinery cannot perform in the usual manner* its impartial task of adjudging cases that are presented for adjudication." *Id.* at ¶59 (internal quotation omitted and emphasis added).

Claims concerning conduct that "threatens the very integrity of . . . the bankruptcy process" and that prevents the court from "perform[ing] in the usual manner" involve the core bankruptcy power. That proposition is no less self-evident because the claims are cast in terms of tort or contract rather than a fee objection, or because the claims are asserted in state court rather than bankruptcy court.

C. Failure To Treat Southmark's Claims As Core Bankruptcy Proceedings Would Undermine The Power Of The Bankruptcy Court To Restructure Debtor-Creditor Relations.

Southmark argues that, to the extent its claims of official misconduct against Coopers do implicate "public rights," those rights were vindicated by the bankruptcy court's order disgorging a portion of Coopers' fees. Therefore, in Southmark's view, it is free to pursue its private rights in another forum.

Such a procedure would seriously undermine the power of the bankruptcy court to control the conduct of court-appointed officers. In the analogous context of a bankruptcy court's denial of leave to sue a trustee in state court, the Seventh Circuit, through Chief Judge Posner, stated:

> At stake in the present case, however, is a concern . . . with the integrity of the bankruptcy jurisdiction. If debtors, creditors, defendants in adversary proceedings, and other parties to a bankruptcy proceeding could sue the trustee in state court for damages arising out of the conduct of the proceeding, that court would

> have the practical power to turn bankruptcy losers into bankruptcy winners, and vice versa.

In the Matter of Linton, 136 F.3d 544, 546 (7th Cir. 1998). Similarly, if debtors are permitted to raise what are essentially fee objections in state court following an adverse decision by the bankruptcy court, the state court in essence gains the power to turn a fee loser into a fee winner.

This instant case is a perfect example of this concern. Southmark became aware of Coopers' alleged misconduct in 1993. It subsequently moved in bankruptcy court for disgorgement of Coopers' entire $4 million fee. In March of 1995, the bankruptcy court ordered Coopers to disgorge $220,000 of its fee, plus pay Southmark's legal fees and costs for its motion. The bankruptcy court also held that Coopers' conduct did not cause Southmark to fail to file timely a proof of claim in the Drexel Burnham Lambert, Inc. bankruptcy case. Neither Southmark nor Coopers appealed this decision and the judgment was immediately paid in full. It was not until after that decision that Southmark filed its state-law claim, alleging virtually identical facts as it had before the bankruptcy court and, in part, seeking the same relief. The fact that Southmark waited until 1995 to bring its state-law action shows that the state-law action is a collateral attack on what Southmark believed to be an unsatisfactory bankruptcy court decision on a core proceeding: the conduct of court-appointed professionals.

Southmark argues that permitting bankruptcy courts to adjudicate claims such as the ones it has asserted against Coopers interferes with the sovereignty of the state courts. To a large extent, this contention is subsumed by the question of whether the claims are core—if the action is a core

proceeding, by definition it is federal in nature. Moreover, a regard for state sovereignty does not mean that states should have the power to interfere with the bankruptcy court's indisputable power to control the award of professionals' fees, as would be the case here.

II. The Courts Of Appeals Are In Agreement That Claims Of Misconduct By Court-Appointed Officers In The Performance Of Their Official Duties Constitute Core Bankruptcy Proceedings.

Southmark argues that the Court should resolve the "[c]onfusion over what claims fall within the core of the federal bankruptcy power." Pet. at 22. Although the Courts of Appeals may differ somewhat on the outer constitutional limits of what constitutes "core proceedings," there is no disagreement that actions of the sort initiated by Southmark against Coopers fall squarely within the constitutional confines of the core of the bankruptcy power.[1]

In addition to the decision of the Fifth Circuit below, three Courts of Appeals have found that actions alleging misconduct of court-appointed persons in the performance of

[1] The vast majority of bankruptcy courts faced with this question similarly have found that claims against court-appointed individuals for alleged misconduct in the performance of their official duties are core proceedings. *See, e.g., In re Envirodyne*, 174 B.R. 955, 964 (Bankr. N.D. Ill. 1994) (claims against official committee members); *In re Elegant Equine, Inc.*, 155 B.R. 189, 191 (Bankr. N.D. Ill. 1993) (action against former trustee for breach of fiduciary duty); *In re American Solar King*, 142 B.R. 772, 773 (Bankr. W.D. Tex. 1992) (breach of fiduciary duty by trustee); *In re Balboa Improvements, Inc.*, 99 B.R. 966, 969 (B.A.P. 9th Cir. 1989) (claims against debtor's attorney for interference with prospective economic advantage, fraud, interference with contract, negligence, malpractice and detriment to the estate).

their official duty constitute core proceedings. In *Sanders Confectionery Products, Inc. v. Heller Financial, Inc.*, 973 F.2d 474 (6th Cir. 1992), debtor's parent corporation sued one of debtor's lenders, the lender's attorneys and the bankruptcy trustee for, *inter alia*, common law fraud, securities fraud and RICO violations arising from the making and administering of a loan to debtor. In addressing the district court's conclusion that the action was a core proceeding, the Third Circuit pronounced that, although the action against the lender and its attorneys was non-core, the action against the trustee was a core proceeding. *Id.* at 483 n.4. According to the court, "[w]hile the specific causes of action . . . exist independently of bankruptcy cases, an action against a bankruptcy trustee for the trustee's administration of the bankruptcy estate could not." *Id.* Accordingly, because "[a]ll claims against [the trustee] related to his conducted during the . . . bankruptcy," they were core proceedings. *Id.*

The Ninth Circuit reached a similar conclusion in *Walsh v. Northwestern National Insurance Co. (In re Ferrante)*, 51 F.3d 1473 (9th Cir. 1995). In *Ferrante*, a successor Chapter 11 trustee brought an adversary action in the bankruptcy court against the surety of the previous trustee, alleging embezzlement and breach of fiduciary duty by the prior trustee in connection with his administration of the bankruptcy estate. The court held that the successor trustee's action was a core proceeding because it "concern[ed] the administration of the estate." *Id.* at 1476 (quotations omitted). The court explained: "Because this case evokes the Bankruptcy Act's imposition of duties on trustees to administer estate property . . . , it cannot be gainsaid that it involves a core issue." *Id.*

Finally, the Third Circuit, in *Billing v. Ravin, Greenberg & Zackin, P.A.*, 22 F.3d 1242, 1249-50 (3d Cir. 1994), held that a separate malpractice action against debtor's attorneys, who were retained by court order, was part and parcel with debtor's objections to the attorneys' fee application, and therefore was within the bankruptcy court's core jurisdiction. In that case, debtor retained the law firm of Ravin, Greenberg & Zackin, P.A. ("RG&Z"). Following approval of the reorganization plan, RG&Z applied to the court for attorneys' fees, which the debtor opposed on grounds of legal malpractice. The debtor also concurrently brought suit against RG&Z for malpractice in the district court.

On appeal, neither party contested the district court's finding that the malpractice suit constituted a core proceeding, and therefore the issue was not addressed directly by the court. However, in finding that RG&Z did not have a right to a jury trial on the malpractice claims,[2] the court held that, by raising legal malpractice as a defense to RG&Z's application for fees, the claims were converted "into an equitable dispute over a share of the estate." *Id.* at 1253. The court explained, "[t]he close connection between the malpractice action and the objections to fees leads us to conclude that the debtors' allegations of malpractice are part of the process of allowance and disallowance of claims." *Id.* at 1252. Therefore, like the decisions in *Sanders Confectionery* and *Ferrante*, this decision is entirely consistent with the decision of the Fifth Circuit below.

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[2] As noted by Southmark, this Court has explained that a determination that a party is not entitled to a jury trial on an issue before a bankruptcy court is tantamount to a finding that the bankruptcy court has jurisdiction over the claim. *See Granfinanciera*, 492 U.S. at 53 (*quoted in* Pet. at 14 n.4).

Southmark ignores *Sanders Confectionery*, *Ferrante* and *Billing* and cites the Ninth Circuit's decision in *Taxel v. Electronic Sports Research (In re Cinematronics, Inc.)*, 916 F.2d 1444 (9th Cir. 1990), and the Third Circuit's decision in *Torkelson v. Maggio (In re Guild and Gallery Plus, Inc.)*, 72 F.3d 1171 (3d Cir. 1996), to try to show a conflict between the Courts of Appeals. This purported conflict is wholly illusory.

In *Cinematronics*, the Ninth Circuit did not address the issue of whether an action alleging misconduct against a court-appointed person in the performance of his official duties constituted a core proceeding. In that case, debtor was sued in state court by a company unrelated to the bankruptcy. The Chapter 11 trustee brought an action in bankruptcy court against the third-party, alleging a violation of the automatic stay provisions of the Bankruptcy Code (the "stay proceeding"). The third-party responded in the stay proceeding by asserting a counterclaim against the trustee, and a third-party complaint against debtor's president, alleging, *inter alia*, breach of contract and breach of fiduciary duty. Upon motion to determine the court's jurisdiction, the bankruptcy court held that the counterclaims and third-party complaint were core proceedings. Debtor's president thereafter moved in the district court to withdraw the reference to the bankruptcy court so that a jury trial could be conducted on the core issues. The district court denied the motion.

On appeal, the Ninth Circuit held that the third-party complaint against debtor's president did not raise core issues. However, because the court found that the trustee lacked standing to bring an appeal, *id.* at 1148, it never addressed whether the counterclaims against the trustee were core. In fact, the issue was not even before the court because the

trustee neither challenged the bankruptcy court's finding that the counterclaims were core proceedings, nor moved in the district court to withdraw the reference based on his right to a jury trial. *See id.*

Presumably, Southmark is arguing that the court's holding with respect to debtor's president, in essence, is a holding that the claims against the trustee likewise are not core. However, that proposition is wholly untenable. The Ninth Circuit's decision rested squarely on the fact that debtor's president was a non-debtor being sued in his individual capacity. *See id.* at 1450 ("Here, the claims at issue are against Pierce, a nondebtor, in his individual capacity. The claims do not directly affect the estate or the confirmation of the estate's plan."). In contrast, the trustee, as an officer of the court charged with administering the estate, was intimately tied to the bankruptcy proceeding. Moreover, the trustee was not being sued in his individual capacity—the conduct at issue was the trustee's effort to enforce the automatic stay provision on behalf of the estate. Finally, even if there were ambiguity in the court's holding, that ambiguity has evaporated with the Ninth Circuit's holding in *Ferrante*, which indicates clearly that claims against trustees for official misconduct are core proceedings. The decision below does not conflict with *Cinematronics*.

Guild and Gallery also does not address the jurisdiction of the bankruptcy court to hear and decide claims of official misconduct by court-appointed persons. In that case, the debtor, prior to filing for bankruptcy, took possession of several paintings under a bailment contract. After the bankruptcy petition was filed, the owner of the paintings sought their return. One of the paintings was lost, leading to a

lawsuit against the bankruptcy trustee alleging negligence and conversion.

The Third Circuit held that the action was not a core proceeding based on the fact that the trustee's alleged impropriety involved property that never was part of the bankruptcy estate. 72 F.3d at 1173. As such, the alleged misconduct "a fortiori . . . cannot fall within §157(b)(2)(A), which can only be applied to matters concerning the administration of the bankruptcy estate." *Id.* The court in *Guild and Gallery* simply was not faced with the issue presented in this case and therefore the case does not conflict with the decision below.

While Southmark argues that "[m]any other conflicts flow from the uncertainty generated by *Marathon*," Pet. at 23, none of those alleged conflicts are implicated by the Fifth Circuit's fact-bound decision. On the issue raised in the instant case, there is no controversy. Each Court of Appeal addressing, either directly or indirectly, whether claims against court-appointed persons for alleged official misconduct constitute core proceedings has, like the Fifth Circuit, answered in the affirmative.

CONCLUSION

A bankruptcy proceeding is a unique process, and court-appointed professionals play an integral part in that process. In order to ensure that the process functions properly, bankruptcy courts must retain the authority to monitor and control the professionals they appoint. In recognition of this reality, the Fifth Circuit held that Southmark's allegations of misfeasance by Coopers in performing the official duties with which it was charged constituted a core proceeding within the meaning of the Bankruptcy Code and

Marathon. That holding comports with the decisions of this Court, as well as with the decisions of the other Courts of Appeals, and therefore Southmark's petition for a writ of certiorari should be denied.

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IN THE UNITED STATES BANKRUPTCY COURT FOR
DISTRICT OF TEXAS
DALLAS DIVISION

In re

SOUTHMARK CORPORATION,

Debtor.

Case No. 389036324-SAF-11

MOTION TO RECONSIDER AWARD OF FEES TO COOPERS & LYBRAND AND BRIEF IN SUPPORT THEREOF

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SOUTHMARK CORPORATION ("Southmark" or the "Debtor"), hereby submits its Motion to Reconsider Award of Fees to Coopers & Lybrand pursuant to Bankruptcy Rule 9024, incorporating Fed. R Civ. P. 60(b), and in support thereof shows the Court as follows:

STATEMENT OF FACTS

1. Southmark was organized in 1970 as a Maryland real estate investment trust. later known as Southmark Properties. In 1981, Gene E. Phillips and William S. Friedman acquired control of Southmark Properties and appointed themselves chairman and vice-chairman, respectively. Southmark Properties' headquarters was moved to Dallas, Texas, and on May 1, 1982, Southmark Properties was convened to a Georgia corporation and its name was changed to Southmark Corporation.

2. The principal business of Southmark was sponsoring private and publicly syndicated real estate partnerships. Through private and public borrowings, Southmark acquired other real estate companies, as well as a savings and loan association and insurance companies.

3. In April, 1989, fouowing two years of increasing financial distress, Southmark announced a $1 billion write-down of its asset values. This write-down wiped out Southmark's shareholders' equity, reducing equity from $604 million to negative $428 million. On July 14, 1989, Southmark filed a Chapter 11 bankruptcy proceeding in Atlanta. The case was subsequently transferred to Dallas. Under the plan of reorganization adopted by the Bankruptcy Court, holders of Southmark's more than one billion dollars in public debt received approximately five cents on each dollar of

their investment in cash, as well as securities in reorganized Southmark which could be worth as much as another 13 cents on the dollar.

4. From 1982 until shortly before Southmark's bankruptcy in 1989, Drexel Burnham Lambert ("Drexel") served as underwriter, broker and financial advisor to Southmark and several of its subsidiaries. Much of Southmark's dealings with Drexel were directly with the High Yield Department, run by Michael Milken. Through the High Yield Department Drexel was able to foster and sustain the illusion of a liquid market for issues of high yield corporate debt and preferred stock, which eventually and more accuratcly came to be known as "junk bonds." Underwriting junk bond issues and manipulating the junk bond markets earned Drexel exorbitant profits through underwriting fees, markups and trading profits.

5. Issuers of Drexel-underwritten bonds, such as Southmark, were forced through a variety of means to invest a portion of the issue proceeds in junk bonds underwritten by Drexel for other clients. Drexel clients who refused to invest in junk bonds found Drexel unwilling to underwrite further debt or preferred stock issues, which were frequently necessary just to retire maturing debt or redeem earlier preferred stock issues. Drexel clients who did not continue to purchase Drexel-underwritten bonds for their own portfolios also found Drexel unwilling to sell bonds the companies already owned.

6. Through the efforts of Drexel, Southmark raised well over a billion dollars through high-interest public debt issues, which quickly imposed a huge interest expense and principal repayment obligations on Southmark. The debt

incurred by Southmark was well in excess of the legitimate operational needs of the company. Southmark was induced by Drexel to invest the excess funds, over $400 million, in high-yield bonds of other Drexel clients. Southmark ultimately lost substantially in excess of $150 million on these junk bonds in 1988 and 1989. The crushing burden of debt service on junk bond issues, combined with devastating losses in its junk bond portfolio, contributed directly and substantially to Southmark's demise.

7. On July 28, 1989, shortly after it filed for bankruptcy, Southmark moved the Bankruptcy Court for the appointment of an Examiner, stating, "the Debtor believes that it is in the best interests of the estate and this Chapter 11 case to have a disinterested, independent individual review and investigate the pre-Chapter 11 activities of the debtor as they relate to third party transactions and relationships, and potential causes of action against such third parties on behalf of Southmark and the estate." Motion, ¶ 6. Southmark sought "an unbiased, independent assessment as to whether legal action by Southmark against various third parties, including any of its former officers and directors, is appropriate and should be pursued." Id. ¶ 9.

8. On September 8, 1989, the Bankruptcy Court issued an order approving the appointment of Neal Batson, a partner in the firm of Alston & Bird, as Examiner. The order charged the Examiner with the "investigation and review of any allegations of fraud, dishonesty, incompetence, misconduct, mismanagement or irregularity in the management of the pre-Chapter 11 affairs of the Debtor, and ... making recommendations as to causes of action discovered in such investigation and review." The Court specifically authorized the Examiner to retain attorneys and accountants

to assist the Examiner in his investigation and review, with "the fees and expenses of such professionals to be paid from the estate upon proper application" On September 14, 1989, the Court approved the appointment of Alston & Bird as attorneys to assist the Examiner.

9. On September 26, 1989, the Examiner applied to the Court for an order authorizing the employment of Coopers & Lybrand as accountants to the Examiner, to investigate allegations of fraud, dishonesty, incompetence, misconduct, mismanagement or irregularity in the management of the pre-Chapter 11 affairs of the Debtor. The application is attached hereto as Exhibit A.

10. Attached to the application of the Examiner was an affidavit from David A. Carpenter, the engagement partner from Coopers & Lybrand. In paragraph 3 of that affidavit. Carpenter listed all "known connections" between Coopers & Lybrand and other parties in interest. Mr. Carpenter noted that "Coopers & Lybrand provides accounting and consulting services for Drexel in matters unrelated to this case." Mr. Carpenter did not indicate that Coopers & Lybrand's relations with Drexel would in any way impede or interfere with its duties as accountants to the Examiner

11. The appointment of Coopers & Lybrand was subsequently approved by the Court, pursuant to section 105(a) of the Bankruptcy Code, effective September 26, 1989. This Court noted that, "[w]hile the court could direct that the appointed examiner use the services of the committee's court-appointed accountant, that might defeat the objective of a disinterested examiner not associated with or serving creditors or equity security holders," In re Southmark Corporation, 113 BR. 280, 282 (Bankr N.D. Tex. 1990).

12. Most of the investigative work between September 26, 1989 and July 9, 1990, the date of the Examiner's final report, was performed by Coopers & Lybrand. Indeed, Coopers & Lybrand itself wrote substantial portions of the various interim and final reports filed by the Examiner.

13. On or about October 1, 1989, there was an initial meeting of the Coopers & Lybrand engagement team, which consisted of David Carpenter, Knute Kurtz (a new partner working under Carpenter), and a number of managers, including Selene Yu, David Kennedy, Steve Schocket and William Galbally. At that meeting, Carpenter assigned various members of the team to work on and investigate specific issues concerning the Southmark bankruptcy. Mr. Galbally was assigned to investigate issues including but not limited to possible avoidance claims that Southmark might have against Drexel arising, inter alia, out of Drexel's relationship as underwriter of bonds sold by Southmark and as broker of "high yield" bonds (i.e., payments by Southmark during the ninety days preceding the filing for bankruptcy that might be recoverable by Southmark).

14. Between October 2, 1989 and approximately December 4, 1989, Mr. Galbally worked on various litigation issues including possible claims against Drexel. As his work progressed, Mr. Galbally came to believe that Southmark's claims against Drexel were potentially the most significant and valuable of all the claims Southmark might pursue. In particular, Mr. Galbally believed that Southmark had substantial claims against Drexel in connection with Drexel's activities as underwriter of bonds issued by Southmark and as broker for bonds purchased by Southmark. Prior to December 4, 1989, Mr. Galbally told Mr. Kurtz among

others, about the potential significance of the claims against Drexel.

15. On or about the night of December 4, 1989, Mr. Carpenter and Mr. Kurtz visited Mr. Galbally at the apartment in Dallas that Mr. Galbally shared with David Kennedy. According to Mr. Galbally, Mr. Carpenter asked Mr. Galbally what he (Galbally) had on Drexel. Mr. Galbally told Mr. Carpenter that Southmark's claims against Drexel were the most important in the engagement, that there appeared to be substantial misconduct by Drexel, and that Drexel had very deep pockets. According to Mr. Galbally, Mr. Carpenter became extremely angry and screamed repeatedly at Mr. Galbally. Mr. Carpenter told Mr. Galbally not to pursue the Drexel issues any further. Mr. Carpenter shouted at Mr. Galbally, among other things: "Don't [mess] with Drexel. Drexel is our largest audit client." When Mr. Galbally insisted that the Drexel issues had to be investigated, Mr. Carpenter told Mr. Galbally that he (Galbally) was being taken off the issues related to Drexel. Mr. Galbally was subsequently Sent to Atlanta to work on Southmark preference actions under the supervision of David Kennedy, even though Mr. Kennedy was Mr. Galbally's junior at Coopers & Lybrand. See Affidavit of William Galbally, attached hereto as Exhibit B.

16. On or about January 3, 1990, the potential claims against Drexel were reassigned to Jeffrey Kessler. Despite billing time to the Drexel matter, Mr. Kessler never developed a basis for claims against Drexel as identified by Mr. Galbally. On information and belief, Mr. Kessler, among others, knew why Mr. Galbally had been reassigned, and this knowledge effectively chilled any further Coopers & Lybrand investigation of the Drexel claims identified by Mr. Galbally.

17. On February 13, 1990, Drexel's parent, The Drexel Burnham Lambert Group, Inc. ("Drexel Group"), filed a petition for relief under chapter 1 1 of the Bankruptcy Code. The court in the Drexel Group bankruptcy set October 1, 1990 as the bar date for the assertion of pre-petition claims against Drexel Group,

18. On March 1, 1990, John C. Weitnauer of Alston & Bird, wrote to R. Paul Wickes, Thompson & Knight, to explain that Southmark might wish to pursue certain claims against Drexel in connection with the Examiner's review of potential preferential transfers, of which Drexel may have received $985,000 or more. Mr. Weitnauer's letter did not however, mention any potential claims Southmark might have against Drexel arising out of Drexel's activities identified by Mr. Galbally, including those as underwriter of bonds issued by Southmark and as broker for bonds purchased by Southmark.

19. On April 17, 1990, Neal Batson sent a letter to R. Paul Wickes, Thompson & Knight (with copies to David Carpenter and Knute Kurtz) advising Thompson & Knight to pursue a "potential voidable preference paid to Drexel Burnham Lambert Incorporated ... within the ninety-day period prior to Southmark's Chapter 11 filing on July 14, 1989." In this letter, the Examiner specifically states that he and his experts "have not attempted to invesrigate" any "securities claims which Southmark may have as the purchaser of bonds underwritten or sold by Drexel." The Examiner also stated that "[i]n light of the plan requirement that the Examiner file his final report by the conclusion of the hearings on confirmation and the recent bankruptcy of the parent, we are not inclined to devote additional resources to a further investigation of any potential Southmark claims against Drexel." A

true and correct copy of the April 17, 1990 letter is attached hereto as Exhibit C.

20. On May 1, 1990, the Examiner filed his Fourth Interim Report (the "Report"). Despite the disclaimer in the Examiner's April 17 letter stating that he and his experts had not investigated claims which Southmark may have as the purchaser of bonds underwritten or sold by Drexel, this Report purported to deal with precisely those claims. The Report, which was written by Coopers & Lybrand. notes that "Southmark's access to the high-yield bond market was largely due to the efforts of Drexel" and that Southmark lost large amounts of money by buying on margin from Drexel a large portfolio of high-yield bonds. The Report then states that Drexel's role in these activities "was investigated more extensively [than other aspects of the Drexel relationship] because of the general, oft-repeated, potential charge that Drexel clients had to support the high-yield bond network."

21. The Report notes that "[p]ublic allegations involving Drexel and the support of the high-yield bond network revolve round allegations of Drexel's underwriting of high-yield bond issuances for companies with the understanding that the company would use part of the proceeds to purchase the high-yield bonds of other Drexel clients, thus helping to create what effectively would be a false market for these high-yield instruments." The Report, however, states at page 41 that proving these allegations was "made difficult by the facts." The Report states that any "ultimate proof" of Drexel's wrongdoing "must await examination of the involved parties." The Report goes on to note that "[s]uch examinations have not, and will not be a priority for the Examiner as any claims against Drexel Burnham Lambert and/or Michael Milken could be of limited value due to the

[Drexel bankruptcy] and [Milken's indictment on criminal charge]." The Report then states that the Examiner had specifically referenced these issues to Southmark's legal counsel. In fact, no such reference was ever made. True and correct copies of excerpted portions of the Fourth Interim Report are attached hereto as Exhibit D.

22. William Galbally read the portions of the Report dealing with Drexel before it was sent to the Examiner for his approval. According to Mr. Galbally, he told Mr. Kessler that the Report on Drexel was completely inadequate and that Coopers & Lybrand had an obligation either to investigate the Drexel issues fully and fairly or else to explain to the Examiner that, because of Drexel's status as a major audit client of Coopers & Lybrand. the firm had decided not to investigate Drexel. Mr. Galbally further told Mr. Kessler that the sort of self-serving disclaimer put in the Report, shifting the responsibility for investigation to counsel for Southmark, was improper. According to Mr. Galbally, Mr. Kessler responded that Mr. Carpenter wanted the Drexel issues handled this way and that he (Mr. Kessler) was not going to delve into the substance of those issues in the Report.

23. On July 9, 1990, the Examiner filed his Final Report. In the Final Report, which was also written by Coopers & Lybrand, Coopers & Lybrand provides yet another excuse for its failure fully to investigate potential claims against Drexel. Appendix I to the Final Report states that "[t]ime has not permitted a complete investigation into the awareness of... Drexel Burnham about the true financial condition of Southmark or the soundness of its business methods and operations. The Examiner has requested Southmark's counsel, Thompson & Knight to undertake the necessary

investigation into/and pursuit of any claims against Drexel Burnham While these outside professionals must have been aware of the specific actions they took, the Examiner has not evaluated their levels of knowledge and whether they fully appreciated how their actions may have produced and maintained the Southmark mirage." The Final Report acknowledges, however, that "'the Southmark mirage could not have been projected without the assistance, inadvertent or intentional, of these outside professionals." The Final Report then state that since Drexel filed for bankruptcy during the pendency of Southmark's bankruptcy, "the Examiner left to counsel for Southmark the necessary investigation into and pursuit of any claims against Drexel Burnham The Examiner does not know whether Southmark's counsel has taken any action in this regard." In fact, there was never any specific reference of claims against Drexel to Southmark's counsel, and Coopers & Lybrand never provided outside counsel for Southmark with any investigative material with respect to potential claims against Drexel. True and correct copies of excerpted portions of the Final Report are attached hereto as Exhibit E.

24. At no time during the course of Coopers & Lybrand's engagement on the Southmark bankruptcy did Coopers & Lybrand inform the Examiner, counsel for Southmark, or Southmark itself that Coopers & Lybrand was holding back from a full investigation of potential claims that Southmark might have against Drexel in order to protect Coopers & Lybrands lucrative audit engagement with Drexel.

25. At no time during the course of Coopers & Lybrand's engagement on the Southmark bankruptcy did Coopers & Lybrand inform the Examiner, counsel for Southmark, or Southmark itself that the Coopers & Lybrand

employee originally charged with investigating the Drexel claims believed, contrary to the Reports prepared for the Examiner, that Southmark had substantial claims against Drexel arising out of Drexel's activities as underwriter of bonds issued by Southmark and as broker for bonds purchased by Southmark.

26. Coopers & Lybrand failed to investigate claims against Drexel that one of its managers considered to be perhaps the most significant claims held by Southmark. According to that manager, who is still today a Coopers & Lybrand employee, the investigation was blocked due to a conflict of interest never disclosed to Southmark to the Examiner or to this Court. Indeed, upon information and belief, Mr. Carpenter went out of his way to convince the Examiner and his counsel that the Drexel audit relationship would not impair the thoroughness of the investigation of Drexel claims.

27. Beyond the failure to investigate (or to disclose why it could not investigate) Drexel claims, Coopers & Lybrand drafted the Examiner's Fourth Interim Report to suggest that it had dome some investigation of such claims and that such claims would be difficult to prove.

28. Southmark emerged from bankruptcy in August 1990. One of the first major decisions for reorganized Southmark was whether to engage outside professionals to investigate further claims against Drexel in order to be in a position to file a claim in the Drexel Group bankruptcy on or before the October 1, 1990 bar date imposed in that case. Due to a combination of factors including Southmark's limited liquidity at the time and the express and implicit lack of enthusiasm for such claims in the Examiner's report, Southmark

did not pursue a further investigation at that time and did not file a claim in the Drexel Group bankruptcy.

29. In early 1991, its coffers somewhat increased, Southmark engaged an outside law firm to investigate the Drexel claims for purposes of the possible filing of a claim against a fund set up by Mr. Milken to compensate defrauded Drexel investors. That investigation revealed the existence of claims virtually identical to the claims Mr. Galbally wanted to further investigate.

30. Southmark proceeded to file a claim against the Milken settlement fund for more than $600 million. Although negotiations are still ongoing, Southmark believes that the magnitude of its claim entitles it to a significant part of the $250 million in the Milken settlement fund. Had Southmark filed a claim in the Drexel Group bankruptcy - which it surely would have done had Mr. Galbally's theories been further investigated and disclosed - Southmark likely would have recovered many millions of dollars on that claim as well.

31. On or about March 5, 1991, this Court issued its Memorandum Opinion and Order on Final Applications for Compensation for Professional Persons and approved Coopers & Lybrand fees and expenses in this case in the approximate amount of $3.7 million.

32. In the early part of 1993, Southmark learned from a former Coopers & Lybrand employee that Mr. Galbally wanted to speak with Southmark about what had happened. Notwithstanding the obvious peril to his own career, Mr. Galbally told Southmark about the events that give rise to this motion. Since that disclosure, Southmark has had

a number of discussions with Coopers & Lybrand in an attempt to resolve this matter. Those discussions have not led to a resolution, and Southmark therefore brings this motion for determination by the Court of whether Coopers & Lybrand should be required to disgorge some or all of the fees previously awarded by the Court.

ARGUMENT

A. Jurisdictional Statement

33. This Court has jurisdiction over this Motion pursuant to 28 U.S.C. § 1334 and the plan of reorganization confirmed by this Court.

B. Introduction: Requirements For Employment Of Professionals In Bankruptcy

34. Professionals in the bankruptcy process owe a fiduciary duty, not only to the parties they represent, but also to the court. *In re Allegheny International Inc.*, 134 BR. 814, 820 (Bankr. W.D. Pa. 1991). "The professionals must be capable of proving that all actions taken are ethical and accomplished in good faith." *Id.*

35. In order to ensure that bankruptcy professionals live up to their fiduciary duty of good faith, the Bankruptcy Code sets forth certain employment and disclosure requirements. Section 327(a) of the Bankruptcy Code sets forth a two part test for the appointment of a professional person: (1) the professional may not hold or represent an interest adverse to the estate and (2) the professional must be a disinterested person. 11 U.S.C. § 327(a).

36. Additionally, Bankruptcy Rule 2014 sets forth the disclosure requirements for employment pursuant to Bankruptcy Code sections 327, 1103 or 1114. An application for the employment of a professional person requires disclosure "at any time during such person's employment" of, among other things, "all the professional's connections with the debtor, Creditor, any other party in interest, their respective attorneys and accountants." The statutory basis for denial of compensation is found in Bankruptcy Code section 328(c) which states that if, during the employment of a professional under sections 327 or 1103, a court determines that the professional is no longer disinterested or holds or represents an adverse interest the court may deny compensation for services and reimbursement of expenses. 11 U.S.C. § 328(c).

C. **Coopers & Lybrand Was Not Disinterested As Required By The Bankruptcy Code**

37. Section 101(14) of the Bankruptcy Code defines a disinterested person as one who:

> (A) is not a creditor, an equity security holder, or an insider,. . .
>
> (E) does not have an interest materially adverse to the interest of the estate or of any class of creditors or equity security holders, by reason of any direct or indirect relationship to, connecton with, or interest in, the debtor or an investment banker . . . . or for any other reason

11 U.S.C. § 101(14)

38. In quoting *Collier*, the Fifth Circuit stated that the requirement of disinterestedness:

> Appears broad enough to include anyone who in the slightest decree might have some interest or relationship that would color the independent and impartial attitude required by the Code. ... Indirect or remote association or affiliations, as well as direct, may engender conflicting loyalties.

In re Consolidated Bancshares, Inc., 785 F.2d 1249, 1256 (5th Cir. 1986) quoting 2 Collier on Bankruptcy § 327.03 at 327-19, 20(15th ed. 1985) (emphasis added).

39. The Fifth Circuit went on to say that Congress has determined that, due to the unique nature of the bankruptcy process, the employment of professionals in a bankruptcy case must be subject to strict standards. *Id* fn. 6, citing *In re Cropper Co.*, 35 B.R. 625, 629 (Bankr. M.D. Ga. 1983). Finally, on the subject of disinterestedness, the Fifth Circuit quotes language from *In re Philadelphia Athletic Club, Inc.*, which states as follows:

> Professionals engaged in the conduct of a bankruptcy case should be free of the slightest personal interest which might be reflected in their decisions concerning matters of the debtor's estate or which might impair the high degree of impartiality and detached judgment

> expected of them during the course of administration.

Consolidated Bancshares, 785 F.2d at 1256, n.6, quoting *In re Philadelphia Athletic Club*, 20 B.R. 328, 334 (E.D. Pa. 1982) (emphasis added).

40. It is clear that applying the language of *Consolidated Bancshares* Coopers & Lybrand could not have been held to be disinterested if it had fully disclosed the nature of its relationships with Drexel. Coopers & Lybrand was not free of personal interest and its relationship with Drexel did in fact color the independent and impartial attitude required by the Bankruptcy Code.

41. Coopers & Lybrand will surely point to the fact that it did disclose the existence of the Drexel audit relationship. The nature of that disclosure, however, did not indicate that the Drexel relationship would impede or impair the investigation of claims against Drexel. And once Coopers & Lybrand had made the determination that it would not investigate these claims valued in the hundreds of millions of dollars, surely it had a duty to disclose this conflict to the Examiner, Southmark and the Court, particularly in light of the extensive role Coopers & Lybrand played in the investigation of third party claims,

42. Rather than disclose the conflict, Mr. Carpenter told the Examiner that there was no conflict. To add insult to injury, Coopers & Lybrand then expressly (by noting how difficult it would be to prove such claims) and implicitly (by running up millions of dollars in fees investigating far

less significant claims) downplayed the significance of such claims in conscious disregard to its duties in this case.

43. A similar issue was raised in In re Amdura where the court stated that the past representation of a former client does not create a conflict, unless the professional believes, that for any reason, it would not be able to "diligently and zealously" represent the debtor on the issue involving the former client. *In re Amdura*, 121 B.R. 862, 870 (Bankr. D. Colo. 1990). The court stated that if the former client is "not the band that feeds," and if the firm is not otherwise inhibited, the professional is not prohibited from acting as counsel. On the other hand, where the professional had openly declared an inability or unwillingness to "joust" with an ongoing client, the issues surrounding that client were pervasive, and the ongoing client was a multi-million-dollar-a-year client of the professional, the court stated that it found it difficult if not impossible, to find the professional disinterested. *Id.*

44. Drexel was indeed "the hand that feeds" Coopers & Lybrand and Coopers & Lybrand failed to openly declare to this Court its unwillingness to "joust" with Drexel. Coopers & Lybrand clearly displayed its inability to "diligently and zealously" represent Southmark on issues involving Drexel. In fact, the relationship between Coopers & Lybrand and Drexel perfectly mirrors the relationship in *In re Amdura* that the court found impossible to label disinterested. Coopers & Lybrand declared, albeit not openly, an unwillingness to "joust" with Drexel, the Drexel issues were pervasive and Drexel was a multi-million dollar client. Had this been disclosed to the Court, Coopers & Lybrand could not possibly have been deemed disinterested. Indeed, had the conflict been

disclosed to the Examiner, he almost certainly would not have sought to retain Coopers & Lybrand in the first instance.

D. Coopers & Lybrand Held An Interest Adverse To The Southmark Estate

45. Although the term "adverse interest" is not defined in the Bankruptcy Code itself, the following judicial definition has developed:

> (a) to possess or assert any economic interest that would tend to lessen the value of the bankruptcy estate or that would create either an actual or potential dispute in which the estate is a rival claimant; or
> (b) to possess a predisposition under circumstances that render such a bias against the estate.

In re Diamond Mortg. Corp. of Illinois, 135 BR 78 94 (Bankr N.D. Ill. 1990): *In re Kuykendahl Place Associates, Ltd.*, 112 B.R. 847, 850 (Bankr. S.D. Tex. 1989); *In re Roberts*, 46 B.R. 815, 827 (Bankr. D. Utah 1985) *aff'd in relevant part and rev'd in part*, 75 B.R. 402 (D. Utah 1987); *Roger J. Au & Son, Inc. v. Aetna Ins. Co.*, 64 B.R. 600, 604 (N.D. Ohio 1986).

46. Under the judicial definition of adverse interest, Coopers & Lybrand clearly should have been disqualified from employment by the examiner. Coopers & Lybrand had a predisposition which rendered a bias against the estate in favor of its multi-million dollar client. Not only did it have

a predisposition it actually did "render such bias against the estate" in failing to vigorously pursue the Drexel claims.

47. The Supreme Court has held, in the context of a bankruptcy proceeding, that: "[w]here an actual conflict of interest exists, no more need be shown in this type of case to support a denial of compensation." *In re Woods v. City Nat. Bank & Trust Co.*, 312 U.S. 262, 268, 61 S.Ct. 493, 497 (1940). See also *Consolidated Bancshares*, 785 F.2d at 1256; *In re EWC, Inc.*, 138 B.R. 276, 280 (Bankr W.D. Okl. 1992); *In re Diamond Mortg. Corp. of Illinois*, 135 B.R. at 92; *In re Coay*, 122 B.R. 520, 526 (Bankr. N.D. Ohio 1990); *In re Micro-Time Management Systems, Inc.*, 102 B.R. 602, 606 (Bankr. E.D. Mich. 1989); *In re Kendavis Inc.*, 91 B.R. 742, 752 (Bankr. N.D. Tex. 1988). In other words, no showing of fraud or unfairness need be shown, in fact, nothing more than the conflict itself is required to be shown. Woods, 61 S.Ct. at 497.

48. The Supreme Court gives the following reason for not requiring any showing beyond the actual conflict:

> The incidence of a particular conflict of interest can seldom be measured with any degree of certainty. The bankruptcy court need not speculate as to whether the result of the conflict was to delay action where speed was essential, to close the record of past transactions where publicity and investigation were needed, to compromise claims by inattention where vigilant assertion was necessary or otherwise to dilute the undivided

> loyalty owed to those whom the claimant purported to represent.

Id.

49. As with the discussion of disinterestedness above, based upon Mr. Gallbally's sworn statements, there can be no genuine dispute as to whether Coopers & Lybrand had an actual conflict here. Plainly, it did. Accordingly, under either prong of section 327(a), Coopers & Lybrand was not qualified to work on behalf of Southmark and the Examiner.

E. Coopers & Lybrand's Failure To Disclose Mandates Disgorgement Of Its Fees

50. Pursuant to Bankruptcy Rule 2014 and its predecessor, the professional who seeks to represent the debtor must fully disclose at the time of the application for employment all connections with the debtor, creditors and other parties in interest. See *In re Arlin's Dept Stores, Inc.*, 615 F.2d 925, 931 (2d Cir. 1979); *In re Roberts*, 73 B.R. at 411; *In re Coastal Equities Inc.*, 39 B.R. 304, 308 (Bankr. S.D. Cal. 1984); *In re Diamond Lumber, Inc.*, 88 B.R. 773, 776 (N.D. Tex. 1988). All facts that may be relevant to a determination of whether a professional is disinterested or holds or represents an interest adverse to the debtor estate must be disclosed to the court. See, e.g., *In re Arlin*, 615 F.2d at 931-933; *In re Diamond Lumber*, 88 B.R. at 777, *In re Roberts*, 75 B.R. at 411; *In re Coastal Equities, Inc.*,39 B.R. at 308. The duty to disclose is broad because the court, rather than the professional, must decide whether the facts constitute an impermissable conflict of interest. See *In re Roberts*, 75 B.R. at 410-411; *In re Coastal Equities, Inc.*, 39 B.R. at 308; *In re Diamond Lumber*, 88 B.R. at 777.

51. The duty to disclose is not only predicated on the statutory requirements of Rule 2014, but also the obligation to disclose in the capacity as an officer of the court and fiduciaries. *In re Coastal Equities*, 39 B.R. at 308.

52. Professionals, when making disclosure, are on notice that if the disclosure is inadequate, if the facts are incorrect or if the changing facts and circumstances reveal an actual conflict, and the professional is later proved to be interested, the court is empowered to deny or reduce fees. *In re Sky Valley, Inc.*, 135 B.R. 925, 935 (Bankr. N.D. Ga. 1992). See also *In re EWC, Inc.*, 138 B.R. at 282 ("[p]rofessionals employed for the estate are under a continuing duty to disclose their connections."): *In re Diamond Mortg. Corp.*, 133 B.R. at 90. Furthermore, if the duty to properly disclose is neglected, however innocently, the professional performs the duties to the estate at its peril. *In re Coastal Equities*, 39 B.R. at 308.

53. Many courts have held that failure to comply with the disclosure requirement is an independent basis for denial of all fees under 11 U.S.C. Section 328, The court in *In re EWC, Inc.*, stated as follows:

> Therefore, if, a person has at any time during employment by the estate, any connections with the debtor, creditors, any other party in interest, their attorneys and accountants, . . ." pursuant to Fed. R.Bankr.Pro. 20 14(a), and fails to disclose those 'connections' to the best of his or her knowledge, it is necessary and appropriate that employment of that

> person must be set aside to carry out the provisions of the Bankruptcy Code. Any request for compensation must be denied, and any compensation received must be disgorged.

138 B.R. 276, 280-281 (Bankr. W.D. Okl. 1992). *See also Consolidated Banchsares*, 755 F.2d at 1256 n. 7; *In re Roberts*, 75 B.R. at 412; *In re Coastal Equities*, 39 B.R. at 308; *In re Thompson*, 54 B.R. 311, 316 (Bankr. N.D. Ohio 1983); *In re Marine Outlet, Inc.*, 135 B.R. 154, 156 (Bankr. M.D. Fla. 1991) ("failure to comply with the mandate of Bankruptcy Rule 20 14(a) merits a total forfieture of all fees"); *In re Tinley Plaza Associates. L.P.*, 142 B.R. 272, 278 (Bankr. N.D. Ill. 1992) ("if an attorney does not disclose a conflict arising after employment has been allowed, the court must . . . disgorge any compensation granted during the period the conflict existed"); *In re Micro-Time*, 102 B.R. at 608 (all compensation was denied the trustee and accountant because, had they fully disclosed they would not have been appointed and thus they have nothing on which to base their claim for compensation, despite substantial contribution). Contra *In re Roberts*, 75 B.R. at 412 ("where equities outweigh the need for attorney discipline for failure to disclose potential conflicts, the law does not require the denial of fees and costs"). The court in *In re Micro-Time*, in referring to the complete denial of fees, stated:

> The argument that possible harm . . . could be counter-balanced by greater benefit [to the estate] does not cover the policy considerations which look to the harm to representation, the loss of confidence, etc. Moreover, [i]t is almost

> impossible for a court to determine what benefit has accrued to the estate as opposed to what detriment might have accrued...absent a conflict of interest....

In re Micro-Time, 102 B.R. at 608.

54. Although Coopers & Lybrand disclosed the existence of its relationship with Drexel, it failed to disclose the significance of that relationship and the potential impact on its duties as the accountant to the Court appointed examiner. While this Court endeavored to employ a disinterested examiner to diligently review the potential claims of the estate, Coopers & Lybrand failed to disclose its predisposition to protect its relationship with Drexel and thus tainted the disinterestedness of the Examiner. As noted in *In re Micro-Time*, in hindsight it is impossible for this Court to determine what benefit might have accrued to the estate absent this conflict of interest and what detriment did in fact accrue.

F. **This Motion To Reconsider Is Timely Under Rule 60(B)**

55. Rule 60(b) of the Federal Rules of Civil Procedure, through the operation of Bankruptcy Rule 9024, governs both the rounds and the time limitations for a motion to reconsider a bankruptcy court order.

56. Rule 60(b) provides that:

> [o]n motion and upon such terms as are just, the court may relieve a party or a party's legal representative from a final

> judgment, order, or proceeding for the following reasons: (1) mistake, inadvertence, surprise, or excusable neglect; (2) newly discovered evidence which by due diligence could not have been discovered in time to move for a new trial under Rule 59(b); (3) fraud (whether heretofore denominated intrinsic or extrinsic), misrepresentation, or other misconduct of an adverse party; (4) the judgment is void; (5) the judgment has been satisfied, released, or discharged, or a prior judgment upon which it is based has been reversed or otherwise vacated, or it is no longer equitable that the judgment should have prospective application; or (6) any other reason justifying relief from the operation of the judgment. The motion shall be made within a reasonable time, and for reasons (1), (2), and (3) not more than one year after the judgment, order, or proceeding was entered or taken. A motion under this subdivision (b) does not affect the finality of a judgment or suspend its operation. This rule does not limit the power of a court to set aside a judgment for fraud upon the court...

Fed. R. Civ. P. 60(b) (emphasis added). As is evident from the language of the Rule itself, Rule 60(b)'s one year time limitation for bringing a motion to reconsider does not apply to (a) Rule 60(b)(6) ("any other reason justifying relief from the operation of a judgment"), or (b) fraud upon the court.[1]

57. **Rule 60(b)(6):** The purpose of Rule 60(b)(6), which provides relief from a judgment for "any other reason justifying relief", is to prevent extreme hardship or injustice. *See United States v. McDonald*, 86 F.R.D. 204, 208 (N.D. Ill. 1980). Once hardship or injustice is found, "Rule 60(b)(6) is to be liberally applied to 'accomplish justice.'" Id. In the Fifth Circuit, Rule 60(b)(6) applies where "something more" than mistake, fraud or newly discovered evidence is shown. *See, e.g., Bros. Inc. v. W.E. Grace Mfg. Co.*, 320 F.2d 594, 608-09 (5th Cir. 1963) (Rule 60(b)(6) invoked upon showing of "something more" than mere plea to reopen based upon newly discovered evidence or fraud).

58. Here, Coopers & Lybrand committed fraud by failing to disclose that its substantial relationship with Drexel would preclude its vigorous investigation of claims against Drexel. However, Coopers & Lybrand's activities (as developed more fully herein) go far beyond mere fraud. Here, the "something more" arises from the context of Coopers & Lybrand's misconduct, i.e. Coopers & Lybrand's fiduciary status with respect to the Court, its affirmative duty to

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[1] Both of these exceptions to Rule 60(b)'s one year time limitation appear, based upon the language of the Rule, to apply only to judgments as opposed to orders; however, case law interpreting Rule 60(b) does not support such a rigid interpretation. *See Lucas v. City of Juneau*, 20 F.R.D. 407, 410 (D. Alaska 1957) (Rule 60(b)(6) applies to order as well as judgment); *In re H.B. Michelson*, 141 B.R. 715, 725-26 (Bankr. E.D. Cal. 1992) (fraud on the court is basis for revoking order confirming reorganization plan). Moreover, even if the Rule 60(b)(6) and the fraud upon the court exceptions apply only to judgments, these exceptions still apply under the presented facts since Bankruptcy Rule 9002 defines "judgment", as it is used in the Federal Rules of Civil Procedure including Rule 60(b), to include "any order appealable to an appellate court." Because the order of this Court approving Coopers & Lybrand's fee is an appealable order, it is also a "judgment" pursuant to Bankruptcy Rule 9002.

disclose any potential conflicts of interest to the Court, the requirement of disinterestedness and, most important, the public interest in seeing that the creditors of Southmark are treated fairly and equitably. Shielding one of its largest clients from claims that could have substantially enhanced creditor recoveries was plainly inimical to the interests of Southmark's creditors and a violation of Coopers & Lybrand's fiduciary and statutory duties. Moreover, this type of misconduct threatens the very integrity of, and the public trust in, the bankruptcy process. Consequently, the Court must reconsider its order award of fees to Coopers & Lybrand pursuant to Rule 60(b)(6).

59. **Fraud upon the Court**: Like a motion brought pursuant to Rule 60(b)(6), a motion to reconsider based on fraud upon the court is not subject to the one year time limitation of Rule 60(b). Fed. R. Civ. P. 60(b). "Fraud upon the court" is fraud committed by an officer of the court which affects the judicial machinery in such away "that the judicial machinery cannot perform in the usual manner its impartial task of adjudging cases that are presented for adjudication." *Browning v. Navarro*, 826 F.2d 335, 344-45 n. 12 (5th Cir. 1987); *Budge v. Post*, 544 F. Supp. 370, 377 (N.D. Tex. 1982). The Examiner is an officer and fiduciary of this Court. *See In re Baldwin United Corp.*, 46 B.R. 314, 318-17 (Bankr. S.D. Ohio 1985) (examiner, as non-adversarial officer o the court, operates as a civil grand jury "to ascertain legitimate areas of recovery" for the estate). By concealing the extent of its relationship with Drexel and by failing to develop claims against Drexel. Coopers & Lybrand tainted the Examiner's Interim Reports, and committed a fraud upon this Court. Moreover, Coopers & Lybrand, as court-appointed accountants, were quasi-officers and fiduciaries of this Court. See *In re Food Town, Inc.*, 208 F. Supp. 139, 148-49 & n.6 (D. Md.

1962). By concealing the effect of its relationship with Drexel on the work it was charged to perform and by failing to investigate and/or covering up Southmark's claims against Drexel, Coopers & Lybrand perpetrated a fraud upon both the Court-appointed Examiner and this Court.

60. Consequently, this Motion is not time barred by the one year limitations period set out in Rule 60(b).

CONCLUSION

61. Coopers & Lybrand's failure to disclose its disinterestedness and adverse interest resulted in the very type of injury to the estate that the strict requirements of the Bankruptcy Code seek to avoid. Coopers & Lybrand failed to vigorously pursue certain actions against Drexel creditors. Complete disgorgement here is necessary and appropriate (a) in light of the harm caused Southmark by the Coopers & Lybrand misconduct and (b) to serve as a warning to other professionals that the requirements under the Bankruptcy Code are to be taken seriously and that misleading partial disclosures of conflicts of interest will not be tolerated. Accordingly, Southmark respectfully requests that the Court reconsider the previous award of over $3.7 million in frees and expenses to Coopers & Lybrand and order Coopers & Lybrand to fully disgorge all such fees and expenses to Southmark.

DATED: January 4, 1994.

Respectfully Submitted,

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UNITED STATES BANKRUPTCY COURT FOR THE SOUTHERN DISTRICT OF NEW YORK

IN RE: VYTAUTAS VEBELIUNAS, Debtor

Chapter 7, Case No. 98 B 45466 (TLB)

March 10, 1999, Decided

COUNSEL: Edgar H. Booth, Esq., Donald L. Kuba, Esq., Warren R. Graham, Esq., WARSHAW BURSTEIN COHEN, SCHLESINGER & KUH, L.L.P., New York, New York, for Chapter 7 Trustee.

ROY BABITT, ESQ., Chapter 7 Trustee, New York, New York.

VYTAUTAS VEBELIUNAS, Debtor, Pro se, Richmond Hill, New York.

Alan E. Gamza, Esq., MOSES & SINGER, L.L.P., New York, New York, for Citibank, N.A.

TRACY HOPE DAVIS, ESQ., Office of the United States Trustee, New York, New York.

JUDGES: HONORABLE TINA L. BROZMAN, CHIEF UNITED STATES BANKRUPTCY JUDGE.

OPINION BY: TINA L. BROZMAN

OPINION: OPINION DISQUALIFYING COUNSEL TO CHAPTER 7 TRUSTEE

HONORABLE TINA L. BROZMAN

CHIEF UNITED STATES BANKRUPTCY JUDGE:

Concerns and fears of partisan bias in the House of Representatives and in the voting by Senators rocked the impeachment process of President William Jefferson Clinton. As it turned out, once the Senators viewed the evidence and gave it the weight they deemed appropriate, they did not vote along unified party lines but acquitted the President. I mention this only to illustrate what a destructive force bias can be if it is allowed to go unchecked and how important in the judicial and quasi-judicial arenas it is first to amass reliable evidence and only then to formulate an opinion.[1] In fact, the point in time when an opinion is formed is essential to the distinction between bias on the one hand and reasoned judgment on the other. Today, I address that very issue as it relates to the disinterestedness of counsel to the chapter 7 trustee on account of his clear expression of prejudice against the debtor before any § 341 or other examination of him by the trustee.

I.

A. Procedural History

Vytautas Vebeliunas, the debtor pro se in this converted chapter 7 case, moved to disqualify Roy Babitt, the chapter 7 trustee assigned to his case, by reason of an alleged conflict of interest arising out of a prior representation of the debtor's affiliate by the firm where Mr. Babitt is of counsel but which does not represent him in this matter. In a decision issued

from the bench, I held that there was absolutely no basis in law or fact warranting the trustee's disqualification for a conflict of interest or for any other reason, however, I instructed the trustee to engage substitute counsel because it had become apparent from the pleadings that his counsel, specifically Warren Graham of Warshaw Burstein Schlesinger & Kuh ("Warshaw Burstein"), was not disinterested as required by § 327(a) of title 11 of the United States Code (the "Bankruptcy Code"). Warshaw Burstein expressed shock at my ruling, not only because the firm clearly did not appreciate it,[2] but because it claims it was not put on notice that I was going to raise and address what was in the papers but what the debtor did not address during his oral argument. Being a firm believer in due process and not wishing to deprive anyone of his or her right to be heard, I allowed Warshaw Burstein to respond in writing and then orally at a subsequent hearing.[3] I did this despite the fact that I regarded the issue of counsel's disinterestedness to be sufficiently glaring from the papers submitted that adequate and sufficient notice of its existence was provided. However, that is only my opinion and reasonable minds do differ.

B. Background

1. The Lattingtown Question

Vebeliunas may or may not own a piece of property located in Lattingtown, New York, which was last valued at $ 4.5 million. When he filed his chapter 11 petition, Vebeliunas did not schedule the property, taking the position instead that it is owned by a trust in which he has a 20% interest. Several

banks with liens against the property totaling less than $ 2 million moved to dismiss the chapter 11 case, asserting that Vebeliunas did indeed own the property but that they could pursue foreclosure in state court. Instead, because Vebeliunas may have significant unsecured debt which, if the Lattingtown property is his, possibly could be satisfied in whole by his equity in that property, I converted the case to a chapter 7 liquidation, noting that the trustee was to examine into the ownership question. Roy Babitt was appointed chapter 7 trustee, with Warshaw Burstein being retained as his counsel.

2. The Telephone Call With Monica Setikas

Prior to the debtor's scheduled § 341 examination,[4] Vebeliunas' assistant, Ms. Monica Setikas, telephoned Graham requesting information about the upcoming meeting. Her reason for calling, she claimed, was that Vebeliunas had not received timely notice of it and that the notice he finally did receive contained inaccurate information. In response to her request, Graham allegedly told Ms. Setikas that he did not believe "anything the debtor said in this case," that he was getting a court reporter and that Vebeliunas had better be at the meeting. This conversation was first brought to the court's attention in Vebeliunas' papers moving for the trustee's disqualification. See Vebeliunas Moving Affidavit, P15. In his papers opposing the debtor's motion, Graham recounts the same exchange as follows:

> The Debtor's suggestion in paragraph 15 of the Vebeliunas Affidavit that "Mr. Babitt, without ever speaking to [him], has instructed his

> attorneys not to believe [him]," is also without any factual basis. The Debtor's motion papers then go on to detail a conversation between Monica Setikas, an associate of the Debtor, and Warren R. Graham, a member of the Warshaw Burstein firm, and the author of these papers, quoting Mr. Graham as stating that he "did not believe anything Mr. Vebeliunas said in this case." While that quote is substantially accurate, the skepticism contained therein is entirely predicated on the record and the gross inconsistency of the Debtor's position concerning ownership of the property, with among other things, his previous sworn statements."[5]

See Trustee's Opposition, P19 (emphasis added). However, at the hearing, Graham testified that he did not remember the conversation with any specificity; with respect to his comment expressing his disbelief of Vebeliunas, Graham said he thought that he made that remark in connection with Vebeliunas claims of deficient notice. In their papers moving for reconsideration, neither the firm nor Graham makes any statement reflecting this position. In fact and significantly, the firm's and Graham's affidavits in opposition to disqualification continue to recount Graham's remark to Monica Setikas as one expressing disbelief of anything the debtor had to say in the case generally. See Warshaw Burstein Affidavit in Opposition to Disqualification, P12; Graham Affidavit Annexed to Warshaw Burstein Affidavit in Opposition to Disqualification, P7. In paragraph 7 of Graham's affidavit, he goes through a detailed list of reasons, only one of which was the repeated claim of deficient notice, why "in frustration and exasperation, [he] spontaneously remarked that [Graham] did not believe anything [Vebeliunas] said." Graham Affidavit

Annexed to Warshaw Burstein Affidavit in Opposition to Disqualification, P7. If Graham had wished to clarify the context in which he remarked on the debtor's credibility, he had several opportunities to do so before the de novo hearing. But he did not. Had Graham not changed his story when he testified, it would have been unnecessary to make a credibility determination. But I believe I have no other choice now other than to render such a determination. I find Graham's testimony at the hearing to have been evasive and not credible.

In the most recent brief submitted by Warshaw Burstein in opposition to its disqualification, Warshaw Burstein attempts to justify Graham's conclusions about the debtor by stating:

> it is respectfully urged upon this court that when a debtor swears to directly contrary facts on numerous occasions and transfers the same piece of property numerous times outside the chain of title, it is not essential for the Trustee, or his counsel, to "get his side of the story" prior to concluding that he has no credibility.

See Warshaw Burstein Affidavit in Opposition to Disqualification, P27. Graham also suggested that his frustration and exasperation with the debtor[6] "together with the Debtor's status as a convicted felon [which] gave [Graham] ample justification to doubt [Vebeliunas'] credibility, and did not impose upon [Graham] an additional duty 'to get his side of the story.'" See Graham Affidavit annexed to Warshaw Burstein Affidavit in Opposition to Disqualification, P8. Notwithstanding Graham's statements, Vebeliunas has contended in court papers that the other parties in interest misapprehend

the facts relating to the chain of title of the property and Vebeliunas further says that he has an explanation to support his own view of the documents to which Graham has referred.

II.

Counsel's compliance with the disinterestedness requirement under § 327(a) not only applies at the time of retention but also throughout the case, see In re Granite Partners, L.P., 219 B.R. 22, 32 (Bankr. S.D.N.Y. 1998); Rome v. Braunstein, 19 F.3d 54, 62 (1st Cir. 1994), and is so crucial to the proper functioning of the bankruptcy system that a court may raise it and dispose of it whenever its sanctity is questioned. See In re Martin, 817 F.2d 175, 180 (1st Cir. 1987) (discussing the bankruptcy court's fundamental responsibility to monitor the integrity of the proceedings before it); In re Plaza Hotel Corporation, 111 B.R. 882, 891 (Bankr. E.D. Cal. 1990) (the court has a continuing supervisory role during the case which includes the ability to revisit issues such as disinterestedness whenever appropriate); Booth v. Continental Insurance Company, 167 Misc. 2d 429, 634 N.Y.S.2d 650, 653-654 (Sup. Ct. West. Co. 1995) (citing Wagenheim v. Pomerantz, N.Y.L.J. 7/7/70, p.13, col.7 at p. 14, col.1 (Sup. Ct. West. Co.) (citing cases) ("the judiciary will not close its eyes when the suggestion of impropriety appears on the record and the issue may be raised sua sponte"); In re Kelton Motors, Inc., 109 B.R. 641, 650 (Bankr. D.Vt. 1989); see generally Flushing Savings Bank v. FSB Properties, Inc., 105 A.D.2d 829, 482 N.Y.S.2d 29, 31 (App. Div. 1984). If there was any infirmity in my issuing my prior ruling without advising the firm that I was considering its removal, that infirmity has been cured by the leave I subsequently granted Warshaw Burstein to appear and be heard on this issue. See Kelton Motors, 109 B.R. at 650.

The crux of Warshaw Burstein's argument is that neither the trustee nor trustee's counsel need be disinterested vis-a-vis the debtor and that counsel had no duty to question the debtor before concluding that he is completely untrustworthy. Further, Warshaw Burstein argues, Graham was entitled to disbelieve the debtor pre-examination without compromising counsel's disinterestedness should I find that that standard applies to the firm.

III.

I feel compelled to first put to bed any doubt as to Graham's bias and how I reached the conclusion that he possessed one. The pertinent facts are simple. Prior to any examination of the debtor by the trustee or his counsel in connection with the chapter 7 case, Graham made an unequivocal statement to the effect that he believed Vebeliunas to be a liar. In his affidavits, Graham manifested a further belief that the debtor did not deserve the opportunity to explain himself because he is a convicted felon. See Graham Affidavit annexed to Warshaw Burstein Affidavit in Opposition to Disqualification, P8. WEBSTER'S THIRD NEW INTERNATIONAL DICTIONARY defines prejudice as "a preconceived judgment or opinion" and "an opinion or leaning adverse to anything without just grounds or before sufficient knowledge." WEBSTER'S THIRD NEW INTERNATIONAL DICTIONARY (Merriam-Webster, Springfield Mass. 1981). The same source defines bias as "such prepossession with some object or point of view that the mind does not respond impartially to anything related to this object or point of view."[7] Id. While Vebeliunas may turn out to be guilty, as alleged, of supplying misinformation to the parties in interest, Graham simply cannot have

concluded that Vebeliunas is lying absent a bias or prejudice on Graham's part because there has not been an examination of Vebeliunas, and, therefore, the totality of evidence needed for Graham to have formed a reasoned judgment is not yet available. Quite obviously Graham is biased against the debtor, for when Ms. Setikas merely requested information for Vebeliunas, Graham responded by attacking the debtor's credibility, thereby demonstrating a complete lack of impartiality with respect to anything having to do with him.

Warshaw Burstein and Graham contend that the comments to Ms. Setikas about the debtor were perhaps "impolitic" but not serious enough to raise a question as to counsel's disinterestedness. An impolitic remark is an unwise remark. See id. During his conversation with Ms. Setikas, had Graham quipped "Vebeliunas probably threw out the notice I sent him," that would have been an unwise and inappropriate remark, but not one indicating bias or prejudice. However, telling a debtor's representative that you don't believe a word the debtor says before you have spoken with the debtor is significantly more troubling. It indicates a predisposition not to trust, listen to, believe in or have confidence in that person.

I recognize that, factually at least, this case is unique, unlike any other reported decision. Whereas most of the decisions regarding the propriety of the retention of counsel involve a conflict of interest, this case admittedly does not address an actual, potential or apparent conflict; the debate that surrounds disqualifying conflicts of interest is not implicated here. Jurisprudential precedent on this topic therefore may only serve to guide me as I make inroads into what amounts to be pristine territory. See Board of Education of the City of New York v. Nyquist, 590 F.2d 1241, 1246 (2d Cir. 1979) (quoting Fund of Funds, Ltd. v. Arthur Andersen & Co., 567 F.2d 225, 227 (2d Cir. 1977)).

IV.

The Bankruptcy Code sets forth a two-pronged test for the retention of estate professionals. See 11 U.S.C. § 327(a); 11 U.S.C. § 101(14). In order for the trustee to retain professionals to represent or assist him or her in carrying out the duties spelled out under § 704 of the Bankruptcy Code, those professionals must meet both requirements. See Martin, 817 F.2d at 180; Granite, 219 B.R. at 32; In re Envirodyne Industries, Inc., 150 B.R. 1008, 1016 (Bankr. N.D.Ill. 1993). First, § 327(a) authorizes the trustee, with the court's approval, to employ "one or more attorneys ... that do not hold or represent an interest adverse to the estate;" and second, "that are disinterested persons." 11 U.S.C. § 327(a). The "adverse interest" element in § 327(a) is undefined by the Bankruptcy Code but has been judicially fashioned to mean either (1) the possession or assertion of any economic interest that would tend to lessen the value of the bankruptcy estate or create an actual or potential dispute with the estate as a rival claimant, or (2) a predisposition of bias against the estate. Kravit, Gass & Weber, S.C. v. Michel (In re Crivello), 134 F.3d 831, 835-36 (7th Cir.1998); Smith v. Marshall (In re Hot Tin Roof), 205 B.R. 1000, 1003 (B.A.P. 1st Cir. 1997); Granite, 219 B.R. at 33; Envirodyne, 150 B.R. at 1016-17; In re Roberts, 46 B.R. 815, 827 (Bankr. D. Utah 1985) aff'd in part, modified in part and rev'd in irrelevant part, 75 B.R. 402 (D. Utah 1987). We are unconcerned here with § 327(a)'s first prong, no adverse interest, but are more concerned with disinterestedness, the second prong, because the bias exhibited is against the debtor, rather than the estate.

Unlike the "adverse interest" prong of the test, disinterestedness is delineated in the Bankruptcy Code. So far as relevant here, § 101(14)(E) of the Bankruptcy Code, more commonly known as the catch-all clause, see Granite, 219 B.R. at 32; 3 L. King, COLLIER ON BANKRUPTCY, P327.04[4][e] at 327-43 (15th ed. rev. 1996), defines a disinterested person as one that "does not have an interest materially adverse to the interest of the estate or of any class of creditors or equity security holders, by reason of any direct or indirect relationship to, connection with, or interest in, the debtor or an investment banker specified in subparagraph (B) or (C) of this paragraph, or for any other reason." 11 U.S.C. § 101(14)(E) (emphasis added); see In re Marvel Entertainment Group, Inc., 140 F.3d 463, 476 (3d Cir. 1998) ("One is a 'disinterested person' only if he [or she] has no interest that is materially adverse to a party in interest in the bankruptcy."). It is well-recognized that the meaning of the phrase "interest materially adverse" in the definition of a disinterested person overlaps with that of "interest adverse" in the first prong of § 327(a) and together, they form one hallmark with which to evaluate whether professionals seeking court-approved retention (or to remain retained by the estate) meet the absence of adversity requirements embodied in the Bankruptcy Code. See Martin, 817 F.2d at 180; Hot Tin Roof, 205 B.R. at 1003; Granite, 219 B.R. at 33; In re Leslie Fay Cos., 175 B.R. 525, 532 (Bankr. S.D.N.Y.1994); Envirodyne, 150 B.R. at 1017.

Warshaw Burstein does not deny that it must be disinterested but takes issue with whether it must be so vis-a-vis the debtor, since the latter is not named in the statute. See 11 U.S.C. § 101(14)(E). Only if I determine that the debtor is owed such a duty need I address the second question, which

is whether Graham's bias constitutes a lack of disinterestedness under the second prong of § 327(a).

A. Must Warshaw Burstein Be Disinterested As To The Debtor?

1. The Debtor As A Potential Equity Security Holder

Counsel's obligation to be disinterested runs to the parties in interest. See Marvel, 140 F.3d at 476. In the typical case, the debtor has no standing to be heard on many matters not involving the discharge of debt because the outcome is irrelevant to the debtor when the estate will not generate a surplus. However, cases discussing a chapter 7 debtor's right to be heard when he or she retains an equity interest in the estate hold that the debtor has standing to lodge an objection to a claim against the estate or to participate in litigation surrounding the asset that stands to produce the surplus. See 4 L. King, COLLIER ON BANKRUPTCY, P502.02[2][c] at 502-14 (15th ed. rev. 1996) (debtor is a party in interest and has standing to object to a claim where there could be a surplus after all claims are paid); In re Manshul Construction Corp., 223 B.R. 428, 430 (Bankr. S.D.N.Y. 1998); In re McCorhill Publishing, Inc., 89 B.R. 393, 396 (Bankr. S.D.N.Y. 1988) (in a liquidation under chapter 7, a debtor has standing to object to claims where disallowance of the claims would produce a surplus); In re Sobiech, 125 B.R. 110, 113 (Bankr. S.D.N.Y. 1991); In re Silverman, 10 B.R. 734, 735 (Bankr. S.D.N.Y. 1981), aff'd 37 B.R. 200 (S.D.N.Y. 1982). In In re Gulph Woods Corporation, 116 B.R. 423 (Bankr. E.D. Pa. 1990), the receiver for the plaintiff in an adversary

proceeding commenced against the debtor sought to prevent the debtor from participating in litigation regarding the sale of property of the estate. The receiver argued that the only interest the debtor could have would be a residuary one under § 726(a)(6), which is not an independent interest and therefore unable to confer standing on the debtor to assert a claim against the receiver. The court held that standing in bankruptcy cases is unlike standing in other cases and that "a debtor may participate in litigation if that litigation will generate or protect a surplus in the estate." Id. at 428. In interpreting Silverman, a case from this district which ultimately denied the debtor's request for standing to object to a claim against the estate because the court determined that no surplus would be generated from the claim's disallowance, the Gulph Woods court explained that "the [Silverman] court's language clearly implied that, if the debtor could have shown that there may have been a surplus for his estate, he would have had standing, independent of trustee [sic], to object to the claim in question." Id. at 428-29 (emphasis added).

Pursuant to § 726(a)(6), if all of Vebeliunas' obligations are satisfied, he will be entitled to any surplus proceeds generated by the liquidation of the Lattingtown property.[8] Thus, this debtor should be considered a party in interest, see COLLIER, P502.02[2][c] at 502-14; McCorhill, 89 B.R. at 395 (debtor is a party in interest where he or she will retain a pecuniary interest in the equity of the estate if all the creditors can be paid in full); In re Hutchinson, 5 F.3d 750, 756 (4th Cir. 1993) (party in interest is generally understood to include all persons whose pecuniary interests are affected by the bankruptcy proceedings); In re James Wilson Assoc., 965 F.2d 160, 169 (7th Cir. 1992) (everyone with a claim to the res has a right to be heard before the res is disposed of since that disposition will extinguish all such claims), the legal consequence of which is that Graham ought be disinterested

vis-a-vis Vebeliunas because he is, for all intents and purposes, the potential class of equity security holders under 11 U.S.C. § 101(14)(E). There is no method of protecting Vebeliunas later while a non-disinterested professional is presently in charge of the investigation, should Vebeliunas prove to be the class of equity holders. The only protection can be given now. But the broader point, despite the statute's reference to equity security holders rather than debtors,[9] is that the trustee's professionals cannot be allowed under any circumstances to lack disinterestedness through bias against a debtor given the responsibilities of the trustee in regard to a natural debtor, specifically, to examine into and object to inappropriate proofs of claim (which can inure to a debtor's benefit if the claim is not dischargeable or if there may be a surplus); to investigate into the debtor's financial affairs; if advisable, to oppose the debtor's discharge; and, if there be a surplus, to deliver it to the debtor. See 11 U.S.C. §§ 704(4), (5) and (6) and 726(a)(6).

2. "Or For Any Other Reason"

Separate and apart from whether or not Vebeliunas can be considered tantamount to an equity security holder under § 101(14)(E), there is a strong argument to be made that the "or for any other reason" language at the end of that subsection is intended, as noted by Collier, [10] to permit "the court to find a particular person lacking in disinterestedness for reasons other than the non-exclusive statutory guidelines." Roberts, 46 B.R. at 828 n.26 (citing In re Philadelphia Athletic Club, Inc., 20 B.R. 328, 333 (E.D. Pa. 1982) (quoting I COLLIER BANKRUPTCY MANUAL § 101.13 (1981))). The oft-quoted language [11] that "professionals engaged in the conduct

of a bankruptcy case should be free of the slightest personal interest which might be reflected in their decisions concerning matters of the debtor's estate or which might impair the high degree of impartiality and detached judgment expected of them during the course of administration," [12] lifted from the COLLIER BANKRUPTCY MANUAL excerpt quoted in Philadelphia Athletic Club and Roberts is the manual's conclusion of the function and effect of the "or for any other reason" clause as it affects the meaning of disinterestedness. COLLIER BANKRUPTCY MANUAL § 101.13. Under this view, the definition of disinterestedness pursuant 11 U.S.C. § 101(14) is not exclusive and is an attempt, albeit not a very clear one from the drafting perspective, to allow a court to reject an attorney if it "deems a particular person's associations to be prejudicial to disinterestedness ... even though those associations do not come within the purview of section 101(13)." Id. Although the Second Circuit has not passed on this issue, other Circuits have implicitly endorsed this view by quoting Roberts (and hence the COLLIER BANKRUPTCY MANUAL) when defining disinterestedness. See Crivello, 134 F.3d at 835 (citing In re BH&P, Inc, 949 F.2d 1300, 1308 (3d Cir. 1991) (citing In re BH & P, Inc. 119 B.R. 35, 42 (D.N.J. 1990) (citing In re Glenn Electric Sales Corp., 99 B.R. 596, 601 (D.N.J. 1988) (quoting Roberts, 46 B.R. at 828 n.26)))) (the catch-all clause is sufficiently broad to include any professional with an "interest or relationship that would even faintly color the independence and impartial attitude required by the Bankruptcy Code); Winship v. Cook (In re Cook), 223 B.R. 782, 789 (B.A.P. 10th Cir. 1998) (quoting BH&P, 949 F.2d at 1309 (quoting Roberts, 46 B.R. at 828 n.26))(same). Under this broad view, Graham is required to be disinterested with respect to the debtor regardless of whether or not Vebeliunas is a potential equity security holder.

B. Standards of Disinterestedness

Courts examine the goals and purposes of the disinterestedness requirement in order to understand the full contours of that concept. To be disinterested is "to prevent even the appearance of a conflict irrespective of the integrity of the person or firm under consideration." In re Codesco, 18 B.R. 997, 999 (Bankr. S.D.N.Y. 1982) (quoted in Martin, 817 F.2d at 181; Hot Tin Roof, 205 B.R. at 1003; In re Kendavis Industries International, Inc., 91 B.R. 742, 754 (Bankr. N.D. Tex. 1988)). Further, a disinterested person "should be divested of any scintilla of personal interest which might be reflected in his decision concerning estate matters." Codesco, 18 B.R. at 999 (quoted in Martin, 817 F.2d at 181; Hot Tin Roof, 205 B.R. at 1003; Kendavis, 91 B.R. at 754). The most modest interest or relationship will undo a person's disinterestedness if it "would even faintly color the independence and impartial attitude required by the Code and Bankruptcy Rules." Roberts, 46 B.R. at 828 n. 26 (quoting Philadelphia Athletic Club, 20 B.R. at 334 (quoting COLLIER BANKRUPTCY MANUAL, § 101.13)); Granite, 219 B.R. at 33; COLLIER, P327.04[3][a] at 327-30 (citing and cited in Envirodyne, 150 B.R. at 1017) ("Professional persons employed by the trustee should be free of any conflicting interest which might in the view of the trustee or the bankruptcy court affect the performance of their services or which might impair the high degree of impartiality and detached judgment expected of them during the administration of a case."). From this we see that what is behind prohibiting the existence of a conflict of interest or relationship is the desire to ensure the independence and impartiality of the professional to be retained.

Any determination regarding Graham's disinterestedness would not be complete without also taking into account the fiduciary duties he has as counsel to the chapter 7 trustee. A trustee in bankruptcy, see King v. United States, 379 U.S. 329, 337, 13 L. Ed. 2d 315, 85 S. Ct. 427 (1964); In re Lehal Realty Associates, 101 F.3d 272, 276 (2d Cir. 1996) (a bankruptcy trustee is an officer of the court that appoints him or her); Marvel, 140 F.3d at 474, as well as his or her counsel, are officers of the court. n13 See Securities and Investor Protection Corporation v. Charisma Securities Corporation, 506 F.2d 1191, 1193-1194 (2d Cir. 1974); Grant v. George Schumann Battery and Tire Company, 908 F.2d 874, 884 (11th Cir. 1990); Continental Illinois National Bank & Trust v. Charles N. Wooten, Ltd. (In re Evangeline Refining Company), 890 F.2d 1312, 1323 (5th Cir. 1989). "Where persons perform duties in the administration of the bankruptcy estate, they act 'as officers of the court' and not private persons." Evangeline Refining, 890 F.2d at 1323. "As such, trustees and attorneys for trustees are held to high fiduciary standards of conduct." Id.; Marvel, 140 F.3d at 474; Philadelphia Athletic Club, 20 B.R. at 333 ("the attorney for the trustee had to exercise the same degree of disinterestedness as the trustee himself"); Codesco, 18 B.R. at 999 ("trustee's selection of counsel, however, must be consistent with high standards required of the officers of the federal courts"). These fiduciary duties are owed not only to the entire creditor body but to the debtor as well. See Germain v. The Connecticut National Bank, 988 F.2d 1323, 1330 n.8 (2d Cir. 1993). So the trustee's disinterested counsel must treat with the debtor in accordance with the high standards of conduct expected from fiduciaries in bankruptcy.

Moreover, as an attorney admitted to practice in the State of New York, Graham is subject to the American Bar Association's Code of Professional Responsibility, specifically

Canons 5 and 9, which require that a lawyer exercise independent judgment on behalf of his client and that "a lawyer should avoid even the appearance of impropriety." MODEL CODE OF PROFESSIONAL RESPONSIBILITY, Canons 5 and 9 (1997). Without a doubt, this case differs from the archetypical conflicts case which gives rise to consideration of the Canons. Canon 5 applies by analogy, a situation which is not so unfamiliar in the bankruptcy context because the Canons of Professional Responsibility are not an exact fit in cases involving potentially hundreds of parties and shifting alliances. See Gerald K. Smith, "Standards for the Employment of Professionals in Bankruptcy Cases: A Response to Professor Zywicki's 'Case for Retaining the Disinterestedness Requirement for Debtor in Possession's Professionals,'" 18 MISS. C. L. REV. 327, 357-58 (Spring 1998). If we consider Warshaw Burstein's client to be the trustee and the estate, Canon 5 calls for the firm and, by extension, Graham to exercise independent judgment when making decisions on their behalf, a directive which sounds strikingly familiar to the goals of disinterestedness just discussed. See Martin, 817 F.2d at 181; Hot Tin Roof, 205 B.R. at 1003; Kendavis, 91 B.R. at 754; Codesco, 18 B.R. at 999 (a disinterested person must be devoid of "any scintilla of personal interest which might be reflected in his decision concerning estate matters"); COLLIER, P327.04[3][a] at 327-30.

Most courts acknowledge that to be disinterested also requires an attorney to heed the admonition contained in Canon 9. See Martin, 817 F.2d at 180-81 ("Section 327 is intended ... to address the appearance of impropriety as much as its substance, to remove the temptation and opportunity to do less than duty demands."); Hot Tin Roof, 205 B.R. at 1003; Granite, 219 B.R. at 34 (despite the fact that the Model Rules of Professional Conduct have dropped the appearance of impropriety standard, § 327(a) nevertheless retains it) n14;

Glenn Electric, 99 B.R. at 601 ("the bankruptcy rules in and of themselves incorporate considerations which are the equivalent of Canon 9's 'appearance of impropriety' standard"); Codesco, 18 B.R. at 999; but see Marvel, 140 F.3d at 477 ("We do not believe that BH&P's discussion of § 101(14)(E)'s disinterest requirement, as applied to the disqualification of a trustee, mandates a conclusion that apparent conflicts alone allow a finding of disinterestedness."[15]).

C. Counsel Is Not Disinterested

Just because there is no conflict of interest does not mean that the disinterestedness standard has not been violated and that there has not been a breach of the Canons of the Code of Professional Responsibility. Where there is a conflict, the fear is that counsel's attention and loyalty are divided by the dual representation or that counsel is swayed by an economic or personal interest so that one party is favored over another. See generally Leslie Fay, 175 B.R. 525 (counsel investigating financial irregularities of debtor in possession failed to disclose relationships with directors who were targets of investigation, thereby calling into question validity of investigation as a result of which counsel was sanctioned and removed from all new matters in case). The bottom line concern is that counsel's independent judgment should not be compromised in any way. If the goal is disinterestedness, whether an attorney holds a bias or instead suffers from the likelihood of tainted judgment as a result of a conflict of interest, the wrong is the same, for his or her ability to maintain independence of judgment will be negatively affected.

Another reason why this case is different from the more typical one is, for lack of a better term, the direction of the bias. While the ratio decidendi of most cases dealing with conflicts of interest centers on the actuality or eventuality that counsel will favor or is favoring one party over another, there is a flip side to this coin. Where one party is actively or purposely favored, another party becomes disfavored. Thus, whether counsel is disfavoring one party over another is equally significant to a court's reasoning in determining whether or not counsel is disinterested. The reason the latter construct is probably less often discussed is because the natural course of events assumes the former: that counsel develops a bent in favor of one party which disturbs the balance of impartiality and causes another party necessarily to become slighted, albeit unintentionally. In other words, counsel may not have started off with any bias against this second party.

Graham's attitude is impossible to reconcile with counsel's fiduciary duties to the debtor as well as his duty to avoid even the appearance of impropriety and to exercise independent judgment. Graham is not disinterested as to Vebeliunas as Graham is required to be, either because Vebeliunas is potentially akin to the class of equity security holders under § 101(14)(E) or because Graham fails the disinterest test pursuant to a more expansive reading of the subsection's last clause. His bias impairs "the high degree of impartiality and detached judgment expected from [counsel to the trustee]" during a case. COLLIER, P327.04[3][a] at 327-30; see supra n.11. Without a doubt Graham has leapfrogged right over the mere appearance of impropriety to land four-square on impropriety itself. This is not a situation where ethical concerns are raised by circumstantial evidence. There is direct evidence of actual bias and prejudice against the debtor. Warshaw Burstein was retained to assist the trustee in performing his duties, such as spearheading the investigation of the

financial affairs of the debtor and advising the trustee to oppose the debtor's discharge, if advisable. See 11 U.S.C. § 704. Graham has a fiduciary duty on behalf of the trustee, the estate and the debtor to carry out these tasks impartially. This is why he must be disinterested. In explaining why counsel for a chapter 11 trustee needed to be disinterested, the court in Philadelphia Athletic Club explained:

> This, of course, ... (was) quite sensible, for it would be anomalous indeed to require a trustee to be aloof from all connection with the debtor or its management, yet permit the trustee's attorney, who would necessarily be active in furthering the trustee's duties of investigation, management, prosecution, development of plans and the like, to have a close relationship with the debtor, its management or associates.

Philadelphia Athletic Club, 20 B.R. at 333 (citing 6 L. King, COLLIER ON BANKRUPTCY, P7.06 at 1203 (14th ed. 1978)). Obviously, in that case, the court was concerned that the trustee's counsel's bias would cause him to favor the debtor over the rest of the creditor body. The converse concern is present in this case, but the same reasoning governs. Given Graham's prejudice, it would be naive on my part to expect Graham to be able now to conduct an impartial, untainted and independent investigation of the debtor, particularly since, in Graham's newest papers and aware of my concerns, he nevertheless asserts that he has no duty to be impartial regarding the debtor and has enough information without ever talking to the debtor to disbelieve him. See Graham Affidavit annexed to Warshaw Burstein Affidavit in Opposition to Disqualification, P8.

D. Disinterestedness Aside, Counsel Should Be Removed

At least one court has found that disinterestedness need not be the exclusive test when evaluating the propriety of an attorney's retention. n16 In In re Kurtzman, 220 B.R. 538 (S.D.N.Y. 1998), the district court affirmed the bankruptcy court's refusal to approve the retention of the chapter 7 trustee's chosen counsel. The bankruptcy court had denied the retention because it believed the law firm to be irresponsible with its billing practices and determined that it would not be in the best interest of the estate for the trustee to retain this particular firm. The district court affirmed, reasoning:

> Indeed, section 327(a) vests the authority for "approval" within the sound discretion of the Court. That authority would be eviscerated were the Court required to approve counsel who met the technical test for disinterest but was ill-suited for other reasons such as, for example, inexperience.

Id. at 542. Recognizing that the Third Circuit's decision in Marvel limited disqualification of an attorney on the basis of conflicts of interest to situations involving actual or potential conflicts, the district court remarked:

Marvel, however, did not bar considerations other than conflict of interest in a court's determination of whether to appoint an attorney as trustee's counsel under § 327(a). Thus, while disinterestedness and the absence of conflicts may be central to the inquiry, they are by no means exclusive.

Id. Applying that rationale to this case, I believe Graham is ill-suited to serve as the trustee's counsel because of his expressed prejudice against the debtor. Cf. Plaza Hotel, 111 B.R. at 891-92 (where debtor's counsel exhibited clear gender bias against the chapter 11 trustee and the United States Trustee and an unwillingness to work with them for that same reason, debtor's counsel was disqualified for his unwillingness to assist the debtor in performing its duty to cooperate with them). In addition, if, indeed, the likely litigation surrounding the Lattingtown property results in a judgment that it is property of Vebeliunas' estate, then there is a possibility that Vebeliunas will receive a distribution in his case. With this in mind, Graham's bias takes on new proportions. His fiduciary obligations to Vebeliunas not only with respect to the latter's bankruptcy discharge but also with respect to his potential equity in the Lattingtown property may be compromised by Graham's partiality and impaired judgment.

V.

Without question, I am vested with the authority to disqualify counsel where there is evidence of lack of disinterestedness or an ethical violation justifying such a sanction. See Cheng v. GAF Corp., 631 F.2d 1052, 1055 (2d Cir. 1980) (disqualification is within the court's discretion); W.T. Grant Co. v. Haines, 531 F.2d 671, 678 (2d Cir. 1976); Martin, 817 F.2d at 182 ("it is for the court to decide whether the attorney's proposed interest carries with it a sufficient threat of material adversity to warrant prophylactic action (say, disqualification or disgorgement or invalidation of a lien)."); Leslie Fay, 175 B.R. at 538 (court has wide discretion in its selection of the appropriate remedy). The Second Circuit, however, generally

disfavors disqualification because it can have an immediate adverse effect on the client by separating him or her from his or her counsel of choice. n17 See Nyquist, 590 F.2d at 1246; In re Wingspread Corp., 152 B.R. 861, 863 (Bankr. S.D.N.Y. 1993). On the other hand, an exception to that general rule has been created where the attorney's conduct tends to taint the underlying trial, see Nyquist, 590 F.2d at 1246; Wingspread, 152 B.R. at 863, with any doubts to be resolved in favor of disqualification. See Hull v. Celanese Corp., 513 F.2d 568, 571 (2d Cir. 1975); Wingspread, 152 B.R. at 863.

In this regard, "disqualification has been ordered only in essentially two kinds of cases: (1) where an attorney's conflict of interests in violation of Canons 5 and 9 of the Code of Professional Responsibility undermines the Court's confidence in the vigor of counsel's representation, or, more commonly, (2) when the attorney is at least potentially in a situation to use privileged information concerning the other side through prior representation... " Nyquist, 590 F.2d at 1246 (citing Fund of Funds, 567 F.2d at 232-33; Cinema 5, Ltd. v. Cinerama, Inc., 528 F.2d 1384 (2d Cir.1976); Emle Industries, Inc. v. Patentex, Inc., 478 F.2d 562, 565 (2d Cir. 1973)). It goes without saying that the inquiry is case-specific. See Nyquist, 590 F.2d at 1246; Martin, 817 F.2d at 182 (the bankruptcy judge is on the front line and in the best position to view the situation and make the delicate judgment calls which a disqualification decision entails).

However, while separating a client from his or her chosen counsel will undoubtedly cause disruption, "where the choice of counsel must be approved by the court as appropriate, such that the integrity of the judicial process is implicated, the cost and delay of replacing counsel with a conflict of interest may be outweighed." Leslie Fay, 175 B.R. at 538 (citing Bohack Corp. v. Gulf & Western Industries, Inc. (In re Bohack Corp.), 607 F.2d 258, 263-64 (2d Cir. 1979)). This is

especially true in the bankruptcy context because "the disinterestedness requirement must be strictly enforced." Hot Tin Roof, 205 B.R. at 1003; Consolidated Bancshares, 785 F.2d at 1256 n.6 ("standards for the employment of professional persons are strict, for Congress has determined that strict standards are necessary in light of the unique nature of the bankruptcy process"); Plaza Hotel, 111 B.R. at 890; Philadelphia Athletic Club, 20 B.R. at 333 (tests of disinterestedness to be rigidly applied); Codesco, 18 B.R. at 1000 (citing Woods v. City National Bank & Trust Co., 312 U.S. 262, 269, 85 L. Ed. 820, 61 S. Ct. 493 (1940) (citing Meinhard v. Salmon, 249 N.Y. 458, 464, 164 N.E. 545 (1928) (Cardozo, J.))) ("only strict adherence to these equitable principles can keep the standard of conduct for fiduciaries 'at a level higher than that trodden by the crowd'"); Michael P. Schuster, "Deciphering Conflicts of Interest in Bankruptcy Representation", 98 COM. L.J. 127, 139 (Summer 1993) (Professional ethical standards are more strictly applied in the bankruptcy context, at least insofar as the retention of professionals by the estate is concerned, in order to maintain the integrity of and respect for the bankruptcy process.).

I have found Graham to be lacking in disinterestedness. To reach this conclusion, I have considered the standards of disinterestedness, the fiduciary duty imposed on counsel as an officer of the court, and the Code of Professional Responsibility. Adopting the analogy between the estate and a client that I suggested before, Graham's prejudice clearly clouds and will continue to cloud his independent judgment when making decisions regarding estate matters in violation of Canon 5, particularly with respect to decisions involving the investigation which he is conducting, the likely Lattingtown property litigation and whether to oppose the debtor's discharge. Inasmuch as Graham is biased, he has also, by definition, committed the "lesser included offense" of not avoiding even the

appearance of impropriety. The breach of Canon 9 is premised on Graham's very real manifestation of impropriety and is not based on any "horrible imaginings alone." Martin, 817 F.2d at 183. Graham is therefore equally subject to disqualification on these grounds since there is a strong threat of taint which would pervade the administration of this case were Graham to remain as counsel to the trustee. See Nyquist, 590 F.2d at 1246. To allow a biased attorney to conduct what is supposed to be an impartial investigation of the debtor, to administer the debtor's estate when the debtor may have an equity therein and to advise the trustee whether to object to the debtor's discharge will undoubtedly engender public suspicion of the integrity of the judicial process. As observed by Judge Friendly in the well-known case In re Ira Haupt & Co., 361 F.2d 164, 168 (2d Cir. 1966), "the conduct of bankruptcy proceedings not only should be right but must seem right." Practically speaking, to consider an economic sanction does not solve the problem because it will leave Graham's bias to reign over the administration of the case. The only way to insure that the investigation of the debtor and the administration of his case are conducted with impartiality and independent judgment is to remove and disqualify counsel from representing the trustee.

VI.

The only remaining issue is whether the whole firm must be disqualified or whether, as the firm requests, only Graham need be removed. The general rule is that when one member of a firm is disqualified, all members of that firm must be similarly disqualified. See United States v. Reynoso, 6 F. Supp. 2d 269, 271 (S.D.N.Y. 1998); Solow v. W.R. Grace &

Company, 83 N.Y.2d 303, 306, 610 N.Y.S.2d 128, 632 N.E.2d 437 (1994); Philadelphia Athletic Club, 20 B.R. at 338 n.11. The reason for this rule is that any interest held by one attorney is imputed to the rest of the lawyers in a firm. If this were not the case, the court would be required to evaluate every other attorney in the firm in order to determine whether they were in fact affected by that interest. See Reynoso, 6 F. Supp. 2d at 271. In correspondence to the court, Edgar Booth, a senior member of Warshaw Burstein who represented that he was speaking on behalf of the whole firm, stated that he has adopted the position espoused by Graham, that neither the trustee nor his counsel is under any duty to give Vebeliunas an opportunity to explain his allegedly questionable behavior because of prior statements by the debtor and the fact that he is a convicted felon. As such, the rationale cited above finds a home in this case as well. If Graham's outlook is to be imputed to Warshaw Burstein, as the firm itself suggests, then the disinterestedness not only of Graham but of the whole firm is defective. The trustee may to some extent be discomfited by having to engage new counsel. However, no § 341 examination has been conducted and the case, while not newborn, is still in its youth. Questions regarding who will administer the Lattingtown property have not even been resolved. Disqualifying counsel may be a set-back in the progress of the case, but it is an unavoidable one, in my opinion. I reiterate my instruction to the trustee to engage new counsel.

SETTLE ORDER on the debtor and the trustee consistent with this decision.

Dated: New York, New York

March 10, 1999

/s/ Tina L. Brozman

CHIEF UNITED STATES BANKRUPTCY JUDGE

----------Footnotes----------

[1] I wish only to use this event in history to describe the potential evils of bias. I express no position whatsoever on the impeachment of President Clinton.

[2] After the hearing, I received a scathing letter from Edgar Booth of Warshaw Burstein, asserting that my ruling had impugned the integrity of not only Graham, but himself and, ultimately, the whole firm. That leap of logic, or illogic, continues to mystify me. Moreover, I am not impugning Graham's integrity as an attorney appearing in this court. What I am saying is that he has exhibited in this case an unfortunate bias which demands his removal.

[3] I have treated this matter de novo, rather than as a motion for reconsideration, inasmuch as Warshaw Burstein questioned whether it received due process the first time round.

[4] To date, no § 341 examination has taken place.

[5] The banks seeking dismissal of the case had asked, when the case was retained, that the state court receiver for the property also be retained. They ultimately withdrew that request in favor of having the trustee administer the property, which, by the way, is income producing. Vebeliunas countered with an assertion that the trustee could not administer the property because it did not belong to the debtor's estate. Graham probably extrapolated from Vebeliunas' petition and his opposition to the request for the trustee to administer the property as well as from documents which the banks showed Graham from the time when their mortgages were granted that Vebeliunas was not credible, despite the fact that Graham

had not yet asked Vebeliunas if there was any explanation for what Graham saw as inconsistencies.

[6] I do not mean to suggest that the debtor is the cooperative, easy-going sort. Graham's frustration and exasperation may be quite legitimate. The issue, however, is not whether Graham has good reason for disliking Vebeliunas.

[7] Quoting Walter Moberly, the dictionary gives a particularly apt illustration of the word's meaning: "The most pernicious kind of bias consists in falsely supposing yourself to have none."

[8] Since standing is limited to parties in interest, see Licensing by Paolo, Inc. v. Sinatra (In re Gucci), 126 F.3d 380, 388 (2d Cir. 1997), if Vebeliunas has standing to object, then he should most obviously also be considered a party in interest.

[9] The lack of precision in the statute may well be due to Congress' desire to have one standard of disinterestedness apply to professionals for all sorts of debtors' estates be they corporate, partnership or natural persons.

[10] In its discussion of the term "disinterested person" as defined in § 101(13) - now renumbered § 101(14) - the Bankruptcy Reform Act of 1978, Collier states:

> The enunciated elements provide a minimum standard for the guidance of the court in its appointments, and insure that the persons employed shall have the essential character of independence and disinterestedness which is required. These elements do not, however, establish an exclusive standard. As was the case under pre-Code bankruptcy practice, (continued by virtue of the "catchall" provision of clause (E)), if a court deems a particular

person's associations to be prejudicial to disinterestedness, it may reject him even though those associations do not come strictly within the purview of section 101(13). Thus, the phrase "or for any other reason" permits the court to find a particular person lacking in disinterestedness for reasons other than the non-exclusive statutory guidelines.

As noted above, clause (E) may be termed a "catch-all clause," and it seems broad enough to include anyone who in the slightest degree might have some interest or relationship that would even faintly color the independent and impartial attitude required by the Code and Bankruptcy Rules. The reasons supporting this extensive inclusion are the same, of course, as those previously recounted. Indirect or remote, as well as direct, associations or affiliations may engender conflicting loyalties.

* * *

It is clear, therefore, that the definition of disinterested person in paragraph (13) promotes the policy that as a general principle professionals engaged in the conduct of a bankruptcy case should be free of the slightest personal interest which might be reflected in their decisions concerning matters of the debtor's estate or which might impair the high degree of impartiality and detached judgment expected of them during the course of administration.

1 COLLIER BANKRUPTCY MANUAL, § 101.13 (1981).

[11] The following case are examples of courts using the "high degree of impartiality and detached judgment" language quoted above or its slight variation "faintly color the independent and impartial attitude required by the Code," also from the same COLLIER BANKRUPTCY MANUAL excerpt, to elucidate disinterestedness: Crivello, 134 F.3d at 835; In re BH & P, Inc. 949 F.2d 1300, 1308 (3d Cir. 1991); Martin, 817 F.2d at 181; Piersen & Gayler, Ray & Terrell & Grubbs v. Creel & Atwood and Jack Bryant (In re Consolidated Bancshares, Inc.) 785 F.2d 1249, 1256 (5th Cir. 1986); Winship v. Cook (In re Cook), 223 B.R. 782, 789 (B.A.P. 10th Cir. 1998); Hot Tin Roof, 205 B.R. at 1003; In re Glenn Electric Sales Corp., 99 B.R. 596, 601(D.N.J. 1988); Roger J. Au & Son, Inc. v. Aetna Insurance Company (In re Roger J. AU & Son, Inc.), 64 B.R. 600, 604 (N.D. OH. 1986); In re Quality Beverage & Company, 216 B.R. 592, 595 (Bankr. S.D. Tex. 1995); Granite, 219 B.R. at 33; In re Prudent Holding Corp., 153 B.R. 629, 631 (Bankr. E.D.N.Y. 1993); Envirodyne, 150 B.R. at 1017; In re Ochoa, 74 B.R. 191, 193 (Bankr. N.D.N.Y. 1987); In re Kendavis Industries International, 91 B.R. 742, 754 (Bankr. N.D. Tex. 1988); Roberts, 46 B.R. at 829; Philadelphia Athletic Club, 20 B.R. at 334 (citing COLLIER BANKRUPTCY MANUAL, § 101.13); In re Codesco, 18 B.R. 997, 999 (Bankr. S.D.N.Y. 1982). [*27]

[12] This language is only slightly modified in the current edition of COLLIER ON BANKRUPTCY. See 4 L. King, COLLIER ON BANKRUPTCY, P327.04[3][a] at 327-30 (15th ed. rev. 1996).

[13] Obviously, both chapter 7 and chapter 11 trustees are officers of the court. Many of the cases discussing the fiduciary duties of a trustee and his or her counsel are those involving chapter 11 trustees, which, independently under the

Bankruptcy Code, must be disinterested. See § 1104(b). Although that may not be a requirement for a chapter 7 trustee elected by creditors, it is a requirement for an interim trustee that becomes a permanent trustee under § 702(d) because interim trustees are required to be disinterested under § 701(a)(1). Such is the case here. Accordingly, those cases describing the fiduciary duties of counsel to a disinterested trustee also apply here.

[14] New York has not adopted the newer American Bar Association's Model Rules of Professional Conduct but adheres to the Model Code of Professional Responsibility.

[15] Although the word "disinterestedness" is employed in this sentence, it is clear from the context that the Third Circuit intended interestedness or lack of disinterestedness. In this vein, because I find Graham has demonstrated bias, my holding that he is not disinterested on that basis does not run afoul of the teachings of Marvel. The Third Circuit in Marvel acknowledged a per se rule for disqualification of counsel holding an actual conflict of interest, a rule for discretionary disqualification of counsel with a potential conflict of interest and a prohibition against disqualification of counsel based on an appearance of conflict alone. See Marvel, 140 F.3d at 476.

[16] If one reads the last clause of § 101(14)(e), "or for any other reason," broadly, as I believe is its proper construction, then Kurtzman could come within the failure of disinterestedness.

[17] Another reason motions for disqualification are frowned upon is that they are often interposed for tactical reasons. See Nyquist, 590 F.2d at 1246. However, this concern is not a factor here considering that I have raised the issue on my own motion.